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SUBCHAPTER S REVISION ACT OF 1982

REPORT

OF THE

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON

H.R. 6055

SEPTEMBER 16, 1982.—Committed to the Committee of the Whole House on the state of the Union and ordered to be printed

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Mr. ROSTENKOWSKI, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 6055]

The Committee on Ways and Means, to whom was referred the bill (H.R. 6055) to revise subchapter S of the Internal Revenue Code of 1954 (relating to small business corporations), having considered the same, reports favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments are shown in the reported bill, with the matter proposed to be stricken in linetype and the matter proposed to be inserted shown in italic type.

I. SUMMARY

In general, the Subchapter S Revision Act of 1982 is intended to simplify and modify the tax rules relating to eligibility for subchapter S status and the operation of subchapter S corporations. This is accomplished by removing eligibility restrictions that appear unnecessary and by revising the rules relating to income, distributions, etc., that tend to create traps for the unwary. The principal changes from present law made by the bill are summarized below.

Eligibility

With respect to initial and continued eligibility of a corporation for subchapter S treatment, the bill makes the following changes:

(1) The number of permitted shareholders will be increased from 25 to 35;

(2) Differences in voting rights in common stock will not violate the one-class-of-stock requirement;

(3) The present law rule which results in the termination of an election if the corporation derives more than 80 percent of its gross receipts from sources outside the United States will be repealed;

(4) The present law rule which automatically terminates a corporation's subchapter S election if more than 20 percent of a corporation's gross receipts for any taxable year is passive investment income will be eliminated for corporations which do not have accumulated earnings and profits from regular corporate years at the close of the taxable year, and will be modified for corporations with accumulated earnings and profits; and

(5) A person who becomes a shareholder of a subchapter S corporation after the initial election of subchapter S status will not have the power to terminate the election by affirmatively refusing to consent to the election. Accordingly, the new shareholder will be bound by the initial election until the election is otherwise terminated.

Elections, revocations and terminations

The bill provides that an election made on or before the fifteenth day of the third month of the taxable year will be effective from the beginning of the taxable year if all persons who held stock in the corporation during the pre-election portion of that year were individuals, estates, and qualified trusts, and if all persons who held stock in the corporation at any time during the year up to the time the election is made consent to the election. If these requirements are not met, or if the election is made later than the fifteenth day of the third month of the taxable year, it will not be effective until the subsequent taxable year.

An event occurring during the taxable year which causes a corporation to fail to meet the definition of an eligible corporation will terminate the election as of the day on which the event occurred (rather than as of the first day of the taxable year in which the event occurred, as under present law). To minimize the effect of an inadvertent termination, the bill provides that the Internal Revenue Service may waive the terminating event so that the corporation may continue to be a subchapter S corporation notwithstanding that event.

The bill provides that an election can be revoked by those shareholders holding a majority of the corporation's voting stock (as contrasted with the current rule which requires all shareholders to consent to a revocation). The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year is modified so that such a retroactive revocation may be filed on or before the fifteenth day of the third month of the taxable year.

Passthrough of income, etc.

The bill provides that the character of items of income, deduction, loss, and credits of the corporation will pass through to the shareholders in the same general manner as the character of such items of a partnership passes through to partners. Thus, for example, such items as tax-exempt interest, capital gains and losses, percentage depletion, the source or allocation of foreign income or loss, and foreign income taxes will pass through and retain their character in the hands of shareholders.

As is the case under present law with respect to losses, income will be passed through and allocated to shareholders on a per-share, per-day basis.

Selection of taxable year

Under the bill, rules generally similar to those applicable to partnerships will apply to the selection of a taxable year for a subchapter S corporation. The taxable year of a corporation which makes a subchapter S election will be required to be either the calendar year, or any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Treasury Department. These rules also apply to corporations currently operating under subchapter S. However, a corporation with a subchapter S election in effect on December 31, 1982, can continue its current taxable year so long as 50 percent or more of the outstanding stock in the corporation on that date continues to be owned by the same shareholder. For purposes of this transitional rule, transfers of stock by reason of death will not be considered changes in ownership.

Carryforward of loss

Under the bill, a subchapter S shareholder will be entitled to carry forward a loss to the extent that the amount of the loss passed through for the year exceeds the aggregate amount of the basis in his or her subchapter S stock and loans to the corporation. The loss carried forward can be deducted only by that shareholder if and when the basis in his or her stock of, or loans to, the corporation is restored.

Distributions

The rules relating to distributions from subchapter S corporations are extensively revised.

Under the new rules, a corporation will not have earnings and profits attributable to any taxable year beginning after the date of enactment if a subchapter S election is in effect for that year. For corporations with no earnings and profits, the amount of the distribution (generally cash plus the fair market value of property) will be tax-free and will reduce the shareholder's basis in his or her stock. To the extent that the amount of the distribution exceeds the amount of the basis in the stock, capital gains generally will result.

For corporations with accumulated earnings and profits, the distribution will be treated as a distribution by a corporation without earnings and profits to the extent of the shareholder's portion of the undistributed amount of subchapter S gross income less deductible expenses (an "accumulated adjustment account"). Any amount in excess of the accumulated adjustment account will be treated under the usual corporate rules, first as a distribution out of accumulated earnings and profits to the extent thereof.

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses, respectively, will serve to increase and decrease the subchapter S shareholder's basis in his or her stock of, and loans to, the corporation. These rules are generally analogous to those provided for partnerships. Also, unlike present law, basis will be restored to debt obligations as well as to stock. Restoration of basis will be made first to debt (to the extent of prior reductions) and then to stock. Under the bill, gain will be recognized by a subchapter S corporation upon nonliquidating distributions of appreciated property.

Fringe benefits

Under the bill, rules similar to the partnership tax rules will apply to employee fringe benefits. For this purpose, persons owning two percent or more of the corporate stock will be treated as partners.

Treatment of transactions between corporation and related parties

Under the bill, amounts accruing to any cash-basis shareholder owning two percent or more of the corporation's stock will be deductible only when paid.

Administration

The bill provides that the items of subchapter S income, deductions, and credits will be determined in audit and judicial proceedings at the corporate level rather than separately with each shareholder. Shareholders would be given notice of, and the opportunity to participate in, Internal Revenue Service proceedings with the corporation.

Effective date

The bill generally will be effective for taxable years beginning after December 31, 1982.

II. REASONS FOR CHANGE

For tax purposes, a corporation generally is treated as a separate entity apart from its shareholders. That is, income earned by the corporation is taxed to it, and distributions from the corporation (either as dividends or in liquidation) also are taxed to the shareholders. A partnership, on the other hand, is not treated as a taxable entity for income tax purposes. Instead, the income of the partnership, whether distributed or not, is taxed to the partners, and distributions by the partnership are generally tax-free.

In many instances, businesses, especially small businesses, may wish to incorporate for business reasons (for example, to obtain limited liability), but would prefer not to have corporate tax treatment. The noncorporate tax treatment may be preferred where the owners wish to have corporate losses pass through to their individual returns (or where most of the owners are taxed at individual income tax rates which are lower than the applicable corporate rate). Alternatively, even if the owners are taxed at individual rates higher than the corporate rate, they may prefer noncorporate tax treatment—assuming they expect to withdraw amounts of the income from the business—in order to avoid the dividend tax on corporate distributions. With the reduction of the maximum individual rate to 50 percent, beginning in 1982, more corporations will find subchapter S treatment attractive.

In light of these considerations, the Congress enacted subchapter S to minimize the effect of Federal income taxes on choices of the form of business organization and to permit the incorporation and operation of certain small businesses without the incidence of income taxation at both the corporate and the shareholder levels.

Because of the passthrough of income and loss to the shareholders of a subchapter S corporation, subchapter S is often described as a method of taxing corporations as if they were partnerships. In fact, there are a number of significant differences in tax treatment under the partnership provisions (subchapter K) and the subchapter S provisions. For example, the partnership provisions provide a complete passthrough of the tax characteristics of the items of income and deduction incurred by the partnership, while the subchapter S provisions do not provide such a passthrough (except for capital gains). Under the partnership provision, a distribution that does not exceed a partner's basis in his or her partnership interest generally is treated as a nontaxable return of capital. In many instances, a similar distribution to a subchapter S shareholder is treated as a taxable distribution. Under the partnership provisions, a loss carryover is allowed to the extent that losses exceed a partner's basis in his or her partnership interest as of the close of the year; in the comparable subchapter S situation, no loss carryover is available.

The experience of taxpayers with subchapter S attests to many "traps" for those not knowledgeable about its technical provisions.

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These unintended adverse tax consequences most often involve (1) unintentional violation of the continuing eligibility rules, resulting in retroactive terminations of elections; (2) the making of taxable distributions which were intended to be tax-free distributions of previously taxed income; and (3) a shareholder's having an insufficient basis to absorb his or her share of the corporation's loss, resulting in the permanent disallowance of that part of the loss.

The history of subchapter S also indicates that knowledgeable taxpayers may have derived some unintended benefits from the subchapter S provisions. Examples of such benefits include the deferral of income resulting from the selection of a taxable year for the corporation which is different from that of the majority of its shareholders, and the use of the retroactive termination provisions of subchapter S to prevent the passthrough of a substantial amount of income to the shareholders.

The committee's bill continues the ability of small business corporations to elect a single level shareholder tax on the corporate earnings and encourages the use of these rules by eliminating unnecessary traps that exist under present law. Also, the bill tries to prevent unwarranted benefits from arising by reason of a subchapter S election.

The committee believes that partnership-like rules which pass items of income and loss through to the corporation's shareholders, with distributions being generally a return of the shareholder's investment including previously taxed earnings, is a simpler and more rational taxing scheme than the modified corporate rules of present subchapter S. Therefore, the bill adopts a partnership approach which treats all items, including such items as depletion, foreign income and fringe benefits generally like they are treated under the partnership provisions.

The committee believes that corporations should continue to be allowed to elect subchapter S without the imposition of a tax which would normally apply if the corporation liquidated and continued business as a partnership. However, in order to prevent a "bail out" of undistributed corporate earnings and profits, the bill will continue dividend treatment for distributions of these earnings. Also the passive income test (as modified) is retained for corporations with accumulated earnings and profits to prevent the conversion of a regular corporation's operating company into a holding company whose income is not subject to a corporate level tax, without the imposition of any shareholder tax on accumulated corporate earnings as would occur if the corporation was liquidated.

III. EXPLANATION OF THE BILL

A. Eligibility for Subchapter S Treatment

Present Law

Under present law, a corporation is eligible to elect and continue subchapter S status only if it (i) has no more than 25 shareholders,[1] (ii) has no shareholder other than an individual who is a citizen or resident of the United States, an estate, or certain types of trusts[2] (grantor trusts, voting trusts, testamentary trusts for a 60-day period, and certain "qualified subchapter S trusts"), (iii) is not a member of an "affiliated group" of corporations, and (iv) has only one class of stock.

Under present law, the courts have ruled that certain purported debt instruments are permissible where their existence offered no tax avoidance possibilities, notwithstanding that under traditional tax concepts these instruments would have normally been considered stock for tax purposes. (e.g., *Portage Plastics Co.* v. *United States*, 486 F. 2d 632 (7th Cir. 1973), and the cases cited therein). The Internal Revenue Service has announced that it will not litigate cases factually similar to the facts in those cases. (TIR–1248 (July 27, 1973).) In addition, under present law, a subchapter S corporation may have outstanding options and warrants to acquire stock, or debentures that are convertible into stock (Rev. Rul. 67–269, 1967–2 C.B. 298).

Explanation of Provisions

1. Permitted number of shareholders (sec. 1361(b)(1)(A))[3]

The number of permitted shareholders will be increased from 25 to 35. This number corresponds to the private placement exemption under Federal securities law.[4]

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[1] The maximum number was set at 10 when subchapter S was enacted and was increased to 15 for certain corportations by the Tax Reform Act of 1976. The Revenue Act of 1978 set the limit at 15 for all corporations. The Economic Recovery Tax Act of 1981 increased the limit to 25.

For purposes of determining the number of shareholders, a husband and wife are treated as one shareholder.

[2] Trusts were not eligible to be shareholders under subchapter S, as enacted. Voting trusts, grantor trusts, and testamentary trusts became eligible shareholders under the Tax Reform Act of 1976. The Economic Recovery Tax Act of 1981 permitted as shareholders, trusts to which sec. 678 applies (under which a person other than the grantor is treated as the owner), and "qualified subchapter S trusts" (i.e., certain trusts in which the income beneficiary elects to be taxed, as the owner).

[3] References are to sections of the Internal Revenue Code of 1954 as proposed to be amended by the bill.

[4] Rule 506 of Regulation D issued pursuant to sec. 4(2) of the Securities Act of 1933.

2. One class of stock requirement (secs. 1361(b)(1)(D) and (c)(4))

The outstanding shares of the corporation must continue to be identical as to the rights of the holders in the profits and in the assets of the corporation. However, unlike present law, differences in voting rights among shares of common stock will be permitted by the bill.

In order to insure that the corporation's election will not terminate in certain situations where the existence of a purported debt instrument (that otherwise would be classified as stock) may not lead to tax avoidance and does not cause undue complexity, the bill provides that an instrument which is straight debt will not be treated as a second class of stock (within the meaning of sec. 1361(b)(1)(D)), and therefore cannot disqualify a subchapter S election. For this purpose, a straight debt instrument means a written unconditional promise to pay on demand or on a specified date a sum certain in money so long as the interest rate, and payment date are fixed. For this purpose these factors are fixed if they are not contingent on the profits of the corporation, the discretion of the corporation, or other similar factors. However, the fact that the interest rate is dependent upon the prime rate or a similar factor not related to the debtor corporation will not disqualify the instrument from being treated under the safe harbor. In order for the "safe harbor" to apply, the instrument must not be convertible into stock, and must be held by a person eligible to hold subchapter S stock.

Because a safe harbor debt instrument may nevertheless be treated as stock under general tax principles, the Secretary of the Treasury or his delegate may prescribe rules or regulations relating to the treatment of these instruments for purposes of applying subchapter S and other provisions of the Code. It is intended that these rules will treat the instrument in such a way as to prevent tax avoidance, on the one hand, and also to prevent unfair, harsh results to the taxpayer. It is anticipated that these safe-harbor instruments will be treated as debt under subchapter S, so that no corporate income or loss will be allocated to the instruments. Payments on the instruments shall be includible in the income of the holder and deductible by the corporation (subject to the rules added by the bill relating to the accrual of unpaid amounts). Payments on these instruments may be examined to determine whether the payments represent interest or other income in any situation where the treatment as interest might give the taxpayer an unwarranted tax advantage, such as under the net interest exclusion.

In the case of a regular corporation (with a straight debt instrument outstanding which is treated as stock under corporate tax law principles) that elects subchapter S, it is intended that the election not be treated as an exchange of debt for stock, but a later redemption of the instrument may be treated as a dividend if the corporation had remaining accumulated earnings and profits. Prior to the issuance of final regulations, it is intended that these general principles will apply to straight debt instruments.

The classification of an instrument outside the safe harbor rules as stock or debt will be made under usual tax law classification principals.

3. Affiliated groups (secs. 1361(b)(2)(A) and (c)(5))

The bill retains the rule that a member of an affiliated group of corporations is not eligible for subchapter S status. Thus, an electing

corporation cannot own 80 percent or more of the stock of another corporation (unless the other corporation has not begun business and has no taxable income).

The bill provides that this rule applies to the holding of any subsidiary, whether or not the corporation is eligible to file a consolidated return with its subsidiary. Thus, a corporation holding a foreign corporation or a DISC as a subsidiary will be ineligible for subchapter S treatment. However, in the case of a corporation which was a subchapter S corporation on June 23, 1982, and held a foreign corporation or DISC as a subsidiary on that date, the election will remain in effect until otherwise terminated, or more than one-half of the stock has been transferred (other than by reason of death).

4. Eligible shareholders (secs. 1361(b)(1)(B), (c)(2), (c)(3) and (d))

Present law is retained. Only individuals (other than nonresident aliens), estates, and certain trusts will be eligible to hold stock in the corporation. Foreign trusts, like foreign corporations and nonresident aliens, will not be eligible shareholders. The committee intends that the qualified trust rules will apply to a usufruct under the principles applicable to a trust.

5. Ineligible corporations (sec. 1361(b)(2))

Financial institutions which are allowed a deduction for bad debts under section 585 or 593, and insurance companies subject to tax under the special insurance company rules of the Code, cannot elect subchapter S.[5] These corporations are entitled to certain deductions not generally allowed to individuals. Many of these corporations are not eligible for subchapter S treatment under present law because of the passive income rules.

Possession corporations, DISC's and former DISC's will continue to be ineligible to elect subchapter S.

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[5] The Internal Revenue Service has ruled that life insurance companies may not qualify as subchapter S corporations under present law (Rev. Rul. 74-344, 1974-2 C.B. 273). The Service has also ruled that stock casualty insurance companies taxable under sec. 831(a) may elect subchapter S treatment (Rev. Rul. 74-437, 1974-2 C.B. 274).

B. Election, Revocation, and Termination

Present Law

Under present law, an election to be taxed as a subchapter S corporation may be made for any taxable year at any time during the preceding taxable year or at any time during the first 75 days of the taxable year. An election continues in effect for subsequent taxable years until it is terminated.

In order for an election to be effective, each shareholder on the day the election is made must consent to the election. If a subchapter S election is terminated, a new election cannot be made by the corporation (or its successor) for any year prior to its fifth taxable year beginning after the taxable year during which the termination is effective, unless the Internal Revenue Service consents to an earlier election.

Under present law, the termination of an election is generally retroactive to the first day of the taxable year in which the terminating event occurred. A termination automatically occurs if the corporation fails to meet any of the eligibility requirements for subchapter S treatment. An election also terminates if all the shareholders of the corporation consent to a revocation. A revocation generally is effective for the following taxable year. Finally, an election can be terminated if a new shareholder affirmatively refuses to consent to the election on or before the 60th day after he or she acquired the stock.

A valid subchapter S election will be terminated if more than 80 percent of the corporation's gross receipts for any taxable year are derived from sources outside the United States, or if more than 20 percent of the gross receipts for any taxable year consist of royalties, rents, interests, dividends, annuities, or gain on the sale or exchange of stock or securities.

Explanation of Provisions

1. Making an election (sec. 1362 (a) and (b))

An election made on or before the fifteenth day of the third month of a corporation's taxable year will be effective beginning with the year when made if the corporation meets all the eligibility requirements (including shareholder eligibility requirements) for the pre-election portion of the taxable year, and if all persons who held stock in the corporation at any time during the portion of the year before the election was made, consent to the election.[6]

If the eligibility requirements are not met for the entire pre-election portion of the year for which the election is made, if consents of all shareholders who had disposed of their stock prior to the making of the election are not obtained, or if the election is made after the fifteenth day of the third month of the year, the election will not become effective until the following taxable year. This rule will prevent any allocation of income and loss to pre-election stockholders who either were ineli-

[6] It is intended that the provisions of Treasury regulation § 1.1372-3(c), allowing the extension of time to file consents, will continue to apply.

gible to hold subchapter S corporation stock or did not consent to the election.

2. Termination of election (secs. 1362(d), (e), and (g))

Generally, specific events during the taxable year which cause a corporation to fail to meet the definition of a small business corporation will result in a termination of the election as of the date on which the event occurred (rather than as of the first day of the taxable year, as under present law). The events causing disqualification will be: (1) exceeding the maximum allowable number of shareholders; (2) transfer of stock to a corporation, partnership, ineligible trust, or nonresident alien; (3) the creation of a class of stock other than the voting and nonvoting common stock allowed; and (4) the acquisition of a subsidiary (other than certain nonoperating subsidiaries).

The day before the day on which the terminating event occurs will be treated as the last day of a short subchapter S taxable year, and the day on which the terminating event occurs will be treated as the first day of a short regular (i.e., subchapter C) taxable year. There will be no requirement that the books of a corporation be closed as of the termination date. Instead the corporation will allocate the income or loss for the entire year (i.e., both short years) on a proration basis.

The corporation can elect, with the consent of all persons who were shareholders at any time during the year, to report the taxable income or loss on each return (subchapter S and subchapter C) on the basis of income or loss shown on the corporation's permanent records (including work papers). Under this method, items will be attributed to the short subchapter S and subchapter C years according to the time they were incurred or realized, as reflected in such records.

The short subchapter S and subchapter C taxable years will be treated as one year for purposes of carrying over previous subchapter C losses. The income allocated to the subchapter C taxable year will be subject to annualization for purposes of applying the corporate rate brackets. The return for the short subchapter S year will be due on the same date as the return for the short subchapter C year is due.

As under present law, if a corporation's election terminates because the passive income limitation (to the extent still applicable) is violated for any taxable year, the election is terminated for that entire taxable year.

If an election is terminated, a new election cannot be made, without the consent of the Internal Revenue Service, for 5 taxable years, as under present law.

3. Revocation of election (sec. 1362(d)(1))

An election can be revoked only by action of shareholders holding more than one-half of the corporation's voting stock.

The present law rule allowing a revocation filed during the first month of the taxable year to be effective for that entire taxable year will be modified. Under the bill, a revocation filed up to and including the fifteenth day of the third month of the taxable year will be effective for the entire taxable year, unless a prospective effective date is specified. The period during which a retroactive revocation can be filed thus will correspond to the time period in which a retroactive election may be made. Revocations made after the fifteenth day of the third month of the taxable year will be effective on the first day of the following taxable year unless the revocation states some other prospective date, in which case it will be effective as of the specified date.

Revocations which designate a prospective effective date will result in the splitting of the year into short subchapter S and subchapter C taxable years with the tax consequences as discussed above in connection with terminations.

A person becoming a shareholder of a subchapter S corporation after the initial election will not have the power to terminate the election by affirmatively refusing to consent to the election (unless that person owns more than one-half the voting stock). He or she will be bound by the initial election.

4. Source of income (secs. 1361(b)(2) and 1362(d)(3) and (4))

The provision of present law that a subchapter S corporation may not derive more than 80 percent of its gross receipts from sources outside the United States will be repealed.

The bill will repeal the requirement that a subchapter S corporation may not have more than 20 percent of its gross income in the form of passive investment income for corporations without accumulated earnings and profits at the end of the taxable year. However, that rule will continue to apply to those corporations which have, at the close of the taxable year, accumulated earnings and profits from years in which the corporation was a regular subchapter C corporation.

In addition, the passive income test is modified to exclude interest on deferred payment sales of property held for sale to customers (within the meaning of sec. 1221(1)) made by the corporation, and income from the conduct of a lending or finance business (as defined in sec. 542(c)(6)). In order to prevent the "churning" of assets, only the net gain from the disposition of capital assets (other than stock and securities) is taken into account in computing gross receipts.

5. Inadvertent terminations secs. 1362(f))

If the Internal Revenue Service determines that a corporation's subchapter S election is inadvertently terminated, the Service can waive the effect of the terminating event for any period if the corporation timely corrects the event and if the corporation and the shareholders agree to be treated as if the election had been in effect for such period.

The committee intends that the Internal Revenue Service be reasonable in granting waivers, so that corporations whose subchapter S eligibility requirements have been inadvertently violated do not suffer the tax consequences of a termination if no tax avoidance would result from the continued subchapter S treatment. In granting a waiver, it is hoped that taxpayers and the government will work out agreements that protect the revenues without undue hardship to taxpayers. For example, if a corporation, in good faith, determined that it had no earnings and profits, but it is later determined on audit that its election terminated by reason of violating the passive income test because the corporation in fact did have accumulated earnings, if the shareholders were to agree to treat the earnings as distributed and include the dividends in income, it may be appropriate to waive the terminating events, so that the election is treated as never terminated. Likewise, it may be appropriate to waive the terminating event when the one class of stock requirement was inadvertently breached, but no tax avoidance had resulted. It is expected that the waiver may be made retroactive for all years, or retroactive for the period in which the corporation again became eligible for subchapter S treatment, depending on the facts.

C. Treatment of Income, Deductions, and Credits

Present Law

Under present law, a subchapter S corporation is not subject to the corporate income tax. An exception to this rule is the imposition of a capital gains tax on certain subchapter S corporations, in order to discourage the making of a "one-shot" subchapter S election.

Instead, the undistributed taxable income of the corporation is includible in gross income of the shareholders owning stock on the last day of the corporation's taxable year. Similar rules pass through the credits of the corporation to its shareholders. Any net operating loss of the corporation is passed through to the shareholders, based on each shareholder's pro rata share of ownership in the corporation during the taxable year. Specific items (such as charitable contributions), other than the long-term capital gain portion of income, do not pass through.

Income may be reallocated by the Internal Revenue Service among shareholders who are family members as necessary to reflect the value of services rendered.

A shareholder may deduct a loss only to the extent of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. Losses in excess of this limitation may not be carried over.

A shareholder's basis in the stock of the corporation is increased by the amount of undistributed taxable income taken into account, and decreased by the shareholder's share of the net operating loss passed through. Losses reduce basis in any indebtedness after the stock basis has been reduced to zero.

Explanation of Provisions

1. Taxation of corporation (secs. 1363(a), 1371(d), and 1374)

As under present law, a subchapter S corporation will not be subject to the corporate income tax, except for the present tax on capital gains. This tax, which is imposed to limit use of subchapter S on a temporary basis in order to pass capital gains through to shareholders, will continue.

Under the bill, the tax imposed under section 47 in the case of an early disposition of property will be imposed on the corporation with respect to credits allowed to the corporation prior to the effective date of the subchapter S election. The election will not be treated as a disposition of the property by the corporation.

2. Treatment of shareholders (secs. 1363(b) and (c), 1366, 1367, 1371(b) and 1373)

In general

The bill sets forth new rules for the taxation of income earned by, and the allowance of losses incurred by, subchapter S corporations.

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These rules generally follow the present law rules governing the taxation of partners with respect to items of partnership income and loss.

Computation of corporate items

A subchapter S corporation's taxable income will be computed under the same rules presently applicable to partnerships under section 703, except that the amortization of organization expenditures under section 248 will be an allowable deduction. As in the case of partnerships, deductions generally allowable to individuals will be allowed to subchapter S corporations, but provisions of the Code governing the computation of taxable income which are applicable only to corporations, such as the dividends received deduction (sec. 243) or the special rules relating to corporate tax preferences (sec. 291), will not apply. Items, the separate treatment which could affect the liability of any shareholder (such as investment interest) will be treated separately. Elections will generally be made at the corporate level, except for those elections which the partners of a partnership may make separately (such as the election to claim the foreign tax credit).

Generally subchapter C will apply, except that a subchapter S corporation will be treated in the same manner as an individual in transactions, such as the treatment of dividends received under section 301, where the corporation is a shareholder in a regular corporation. Provisions relating to transactions by a subchapter S corporation with respect to its own stock will be treated as if the S corporation were a regular corporation. However, the subchapter C rules are not to apply where the result would be inconsistent with the purpose of the subchapter S rules which treat the corporation as a passthrough entity.

Passthrough of items

The following examples illustrate the operation of the bill's passthrough rules:

a. *Capital gains and losses.*—Gains or losses from sales or exchanges of capital assets will pass through to the shareholders as capital gains or losses. Net capital gains will no longer be offset by ordinary losses at the corporate level.

b. *Section 1231 gains and losses.*—The gains and losses on certain property used in a trade or business will be passed through separately and will be aggregated with the shareholder's other section 1231 gains and losses. Thus, section 1231 gains will no longer be aggregated with capital gains at the corporate level and passed through as capital gains.

c. *Charitable contributions.*—The corporate 10-percent limitation will no longer apply to contributions by the corporation. As in the case of partnerships, the contributions will pass through to the shareholders, at which level they will be subject to the individual limitations on deductibility.

d. *Tax-exempt interest.*—Tax-exempt interest will pass through to the shareholders as such and will increase the shareholders' basis in their subchapter S stock. Subsequent distributions by a corporation will not result in taxation of the tax-exempt income. (See discussion below for rules relating to corporate distributions.)

e. *Foreign tax credit.*—Foreign taxes paid by the corporation will pass through as such to the shareholders, who will claim

such taxes either as deductions or credits (subject to the applicable limitations). A subchapter S corporation will not be eligible for the foreign tax credit with respect to taxes paid by a foreign corporation in which the subchapter S corporation is a shareholder; therefore, these taxes will not pass through to its shareholders. The special foreign loss recapture provisions (section 904(f)) will apply to a corporation electing out of subchapter S which had previously passed foreign losses through to its shareholders. Rules concerning the source of income, including the capital gains source rule (section 904(b)), and the amount of creditable taxes, such as the oil and gas foreign tax credit rules (section 907(a)), will apply at the shareholder level.

f. *Credits.*—As with partnerships, items involved in the determination of credits, such as the basis of section 38 property for purposes of computing the amount of qualified investment eligible for the investment tax credit, will pass through to the subchapter S corporation's shareholders.

g. *Depletion.*—The present rules governing depletion with regard to partnership interests in minerals will apply to depletion of properties of a subchapter S corporation (see discussion below for special rules in the case of oil and gas properties).

h. *Foreign income and loss.*—Domestic losses and foreign losses will pass through separately. If a corporation had foreign losses and domestic income, or vice versa, each will pass through separately to shareholders without aggregation at the corporate level.

i. *Other items.*—Limitations on the used property investment tax credit (sec. 48(c)), the expensing of certain depreciable business assets (sec. 179), and the amortization of reforestation expenditures (sec. 194) will apply at both the corporate level and shareholder level, as in the case of partnerships. Exclusions of income from discharge of indebtedness will be determined at the shareholder level (sec. 108). The election to capitalize intangible costs by a shareholder who does not actively participate in the management of the corporation will be the same as the election by a limited partner, i.e. 10 year amortization (sec. 58(i)). The subchapter S corporation will be treated as a middleman with respect to the withholding on payment of interest and dividends it receives (sec. 3453).

Carryovers from years in which the corporation was not a subchapter S corporation will not be allowed to the corporation while in subchapter S status.

Shareholders treatment of items

In general.—As with the partners of a partnership, each shareholder of a subchapter S corporation will take into account separately his or her pro rate share of items of income, deduction, credit, etc., of the corporation. These rules parallel the partnership rules under section 702.

Each shareholder's share of the items will be taken into account in the shareholder's taxable year in which the corporation's year ends. In the case of the death of a shareholder, the shareholder's portion of subchapter S items will be taken into account on the shareholder's

final income tax return. Items from the portion of the corporation's taxable year after the shareholder's death will be taken into account by the estate or other person acquiring the stock.

For these purposes, a shareholder's pro rata share generally will be determined in the same manner as the present law rule for passing through net operating losses. In cases of transfers of subchapter S stock during the taxable year, income, losses, and credits will be allocated in essentially the same manner as when the election terminates during the year. Thus, the allocation generally will be made on a per-share, per-day basis unless the corporation, with the consent of its shareholders, elected to allocate according to its permanent records (including work papers).

A "conduit" rule for determining the character of items realized by the corporation and included in the shareholder's pro rata share will be the same as the partnership rule (sec. 702(6)). Under the partnership rules, this has generally resulted in an entity level characterization. Also, the "gross income" determinations made by a shareholder will parallel the partnership rule (sec. 702(c)).

Worthless stock.—If the corporation's stock becomes worthless in any taxable year of the corporation or shareholder, the corporate items for that year will be taken into account by the shareholders and the adjustments to the stock's basis will be made before the stock's worthlessness is taken into account under section 165(g).

Family members.—Under the bill, items taken into account by members of the family wherever it is necessary to reflect reasonable compensation to the shareholder for services rendered or capital furnished to the corporation. Both the amount of compensation and the timing of the compensation can be so adjusted.

Loss limitations.—As under present law, a shareholder's allowable pro rata share of the corporation's loss will be limited to the sum of the shareholder's adjusted basis in the stock of the corporation plus the shareholder's adjusted basis of any indebtedness of the corporation to the shareholder. However, unlike present law, disallowed losses can be carried forward or allowed in any subsequent year in which the shareholder has adequate basis in such stock or debt.

Foreign losses.—For purposes of computing the amount of foreign losses that must be recaptured under the foreign tax credit rules (section 904(f)), the making or termination of an election to be treated as an S corporation shall be treated as the disposition of a business. Accordingly, when an S election is made, the corporation will be treated as having disposed of its foreign property and will include in income the amount of any foreign losses not previously recaptured. Likewise, when an S election is terminated, the shareholders will be treated as if the corporation disposed of its foreign assets, and the shareholders will include in income the amount of any foreign losses of the corporation previously passed through to them and not previously recaptured.

Terminated election.—Subsequent to a termination of a subchapter S election, these disallowed losses will be allowed if the shareholder's basis in his stock in the corporation is restored by the later of the following dates:

(1) One year after the effective date of the termination, or the due date for the last subchapter S return, whichever is later; or

(2) 120 days after a determination that the corporation's subchapter S election had terminated for a previous year. (A determination will be defined as a court decision which becomes final, a closing agreement, or an agreement between the corporation and the Internal Revenue Service that the corporation failed to qualify.)

3. Basis adjustment (sec. 1367)

Under the bill, both taxable and nontaxable income and deductible and nondeductible expenses will serve, respectively, to increase and decrease a subchapter S shareholder's basis in the stock of the corporation. These rules generally will be analogous to those provided for partnerships under section 705. Under these rules, income and loss for any corporate taxable year will apply to adjust basis before the distribution rules apply for that year. Unlike the partnership rules, however, to the extent property distributions are treated as a return of basis, basis will be reduced by the fair market value of these properties (see below). Any passthrough of income for a particular year (allocated according to the proportion of stock held in the corporation) will first increase the shareholder's basis in loans to the corporation to the extent the basis was previously reduced by the passthrough of losses.

D. Treatment of Corporate Distributions

Present Law

Under present law, the general rules applicable to distributions to shareholders by regular corporations apply to such distributions by subchapter S corporations. Under the normal corporate rules, distributions of money or other property are treated as taxable dividends, at fair market value, to the extent the corporation has either current or accumulated earnings and profits. Distributions in excess of earnings and profits are tax-free up to the shareholder's basis in the stock, and any excess is then treated as gain from the sale of the stock.

In addition to the regular rules, special rules also apply to distributions by subchapter S corporations. These rules allow a corporation to make tax-free cash distributions within 2½ months after the close of the taxable year out of the prior year's undistributed taxable income to the extent of the shareholder's portion of that income (sec. 1375(f)). Also, cash distributions which are not distributions of the prior year's undistributed taxable income and which are in excess of current earnings and profits qualify as tax-free distributions of a shareholder's previously taxed income to the extent of that income (sec. 1375(d)). The right to receive previously taxed income is not transferable and terminates when the corporation's subchapter S election terminates.

Property distributions by subchapter S corporations are treated differently from cash distributions in that they do not reduce the amount of the current year's undistributed taxable income taxed to the shareholder and do not qualify as distributions of either undistributed taxable income or of previously taxed income. Also, property distributions reduce earnings and profits by an amount equal to the adjusted basis of the property distributed.

In summary, distributions of money have the following tax consequences in the following order: (1) a tax-free distribution of undistributed taxable income to the extent thereof, if made within 2½ months after the end of the corporation's taxable year; (2) a dividend to the extent of current earnings and profits; (3) a tax-free distribution to the extent of previously taxed income (a special rule reverses the order of items (2) and (3) in the case of certain accelerated depreciation); (4) a dividend to the extent of accumulated earnings and profits (the shareholder may elect to reverse the order of items (3) and (4)); (5) reduction in the shareholder's basis in the stock of the corporation; and (6) a taxable disposition of the stock.

Property distributions have the following tax consequences under present law: (1) A dividend distribution to the extent of either current or accumulated earnings and profits; (2) reduction in the shareholder's basis in the stock of the corporation; and (3) a taxable disposition of the stock.

Generally, distributions have no tax effect on the distributing corporation, except for distributions of LIFO inventory where the "LIFO reserve" is recaptured, or distributions of property where the liability exceeds basis, which results in gain to the extent of the excess (sec. 311 (a), (b), and (c)).

Explanation of Provisions

1. Taxation of shareholders (secs. 1368 and 1371(c))

Under the bill, the amount of any distribution to a shareholder will equal the amount of cash distributed plus the fair market value of any property distributed, as under present law.

The amount of a distribution by a corporation without accumulated earnings and profits will be tax-free to the extent of the shareholder's basis in the stock. The distribution will be applied to reduce the shareholder's basis in his stock. To the extent the amount of the distribution exceeds basis, capital gains generally will result.

No post-1982 earnings of a subchapter S corporation will be considered earnings and profits for this purpose. Thus, under the bill, a corporation will not have earnings and profits attributable to any taxable year beginning after 1982 if a subchapter S election was in effect for that year. However, a corporation can have earnings and profits attributable to (1) taxable years for which an election was not in effect, (2) taxable years beginning prior to 1983 for which an election was in effect, and (3) a corporate acquisition which results in a carryover of earnings and profits under section 381.

A distribution by a subchapter S corporation with accumulated earnings and profits will be treated as if made by a subchapter S corporation with no earnings and profits up to the amount in the corporation's accumulated adjustment account (i.e., post-1982 accumulated gross income less deductible expenses, not previously distributed). Any excess will then be treated as a dividend up to the amount of accumulated earnings and profits; any residual amount will then be applied against the shareholder's remaining basis in his stock; and, finally, any remainder of the distribution generally will be treated as capital gain.

Thus, under the bill, shareholders of subchapter S corporations with accumulated earnings and profits will be assured of tax-free treatment with respect to distributions, regardless of when made, to the extent of the corporation's accumulated adjustment account.

The rules described above will apply to the transferee of stock in a subchapter S corporation regardless of the manner in which the transferee acquires the stock.

2. Treatment of corporation (sec. 1363(d))

Gain will be recognized by a subchapter S corporation on a distribution of appreciated property, other than distributions in complete liquidation of the corporation, in the same manner as if the property had been sold to the shareholder at its fair market value. Like other corporate gain, it will pass-thru to the shareholders.

Without this rule, assets could be distributed tax-free (except for recapture in certain instances) and subsequently sold without income recognition to the selling shareholder because of the stepped-up fair market value basis.

E. Taxable Year of Corporation

Present Law

Under present law, shareholders of a subchapter S corporation take into account undistributed taxable income and net operating losses for their taxable years in which the subchapter S taxable year ends. No special rules limit the taxable year which the corporation may select. As a result, a deferral of tax can result if a taxable year ending after the end of the shareholder's taxable year is selected.

Explanation of Provision (sec. 1378)

Under the bill, the taxable year of a subchapter S corporation will be required to be either a year ending December 31, or any other table year for which it establishes a business purpose to the satisfaction of the Internal Revenue Service.

A corporation which is a subchapter S corporation during the taxable year which includes December 31, 1982, will be permitted to retain its existing taxable year so long as at least 50 percent of the stock in the corporation is owned by the same persons who owned such stock on December 31, 1982. However, to retain subchapter S status for taxable years beginning after the day on which more than 50 percent of its stock have changed ownership subsequent to December 31, 1982, the corporation will have to conform to the general taxable year rule and either use the calendar year or establish a business purpose for a different year. For these purposes, transfers of shares by reason of the shareholder's death will not be considered changes in ownership.

F. Other Rules

1. Treatment of fringe benefits

Present Law

Under present law, the statutory exemptions for fringe benefits applicable to shareholder-employees of regular corporations also apply in the case of subchapter C corporations. The benefits include the following:

(1) the $5,000 death benefit exclusion (sec. 101(b));

(2) the exclusion from income of amounts paid for an accident and health plan (secs. 105 (b), (c), and (d));

(3) the exclusion from income of amounts paid by an employer to an accident and health plan (sec. 106);

(4) the exclusion of the cost of up to $50,000 of group-term life insurance on an employee's life (sec. 79); and

(5) the exclusion from income of meals or lodging furnished for the convenience of the employer (sec. 119).

Explanation of Provision (sec. 1372)

Under the bill, the treatment of fringe benefits of any person owning more than two percent of the stock of the corporation will be treated in the same manner as a partner in a partnership. Thus, for example, amounts paid for the medical care of a shareholder-employee will not be deductible by the corporation (by reason of secs. 1363 (b)(2) and 703(a)(2)(E)), will be deductible by that individual only to the extent personal medical expenses will be allowed as an itemized deduction under section 213. However, similar amounts paid by the corporation on behalf of shareholders owning two percent or less of the corporation may be deducted as a business expense.

2. Treatment of oil and gas production

Present Law

Under present law, the allowance for depletion, including depletion with respect to oil and gas wells, for a subchapter S corporation, is computed by the corporation and taken into account in determining the taxable income of the subchapter S corporation. The depletion deductions taken into account in determining earnings and profits of a subchapter S corporation are computed based on cost depletion. Thus, when a subchapter S corporation claims percentage depletion, it may generate current earnings and profits in excess of taxable income, and amounts distributed in excess of taxable income may be taxed as a dividend to the shareholders.

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The right to claim percentage depletion with respect to oil and gas wells is limited under present law to certain independent producers and royalty owners. To prevent a proliferation of interests eligible for percentage depletion, present law provides anti-transfer rules which limit the ability of transferees to claim percentage depletion on production attributable to an interest in proven oil or gas properties transferred after 1974. Generally, a transfer from an individual to a subchapter S corporation will result in the loss of percentage depletion unless the special rules provided in section 613A(c)(10) are satisfied. In essence, these rules require that the corporation's stock be issued solely in exchange for oil and gas properties and that there be an allocation of the barrel-per-day limitation on percentage depletion between the corporation and the individuals contributing the property. Similarly, the transfer of an oil and gas property from the subchapter S corporation to one or more of the shareholders will result in the loss of percentage depletion for production from the transferred property. However, the subchapter S election by a regular corporation is not treated as a transfer (Rev. Rul. 80–43, 1980–1 C.B. 133).

Under present law, the windfall profit tax is imposed upon the producer of domestic crude oil. In the case of a subchapter S corporation, the producer of crude oil is the corporation and not the individual shareholders. The transfer of property from or to a corporation would be a transfer resulting in the loss of lower rates on production by independent producers, unless one of the specified exceptions to the anti-transfer rules applied.

Explanation of Provisions (secs. 613A, 4992 and 4996)

Under the bill, the allowance for depletion in the case of oil and gas properties held by a subchapter S corporation will be computed in a manner similar to that used in the computation of depletion in the case of partnerships. Specifically, the percentage or cost depletion allowance will be available directly to the shareholders of the subchapter S corporation and will be computed separately by each individual shareholder. Each shareholder will be treated as having produced his or her pro rata share of the production of the subchapter S corporation and each shareholder will be allocated his or her respective share of the adjusted basis of the subchapter S corporation in each oil or gas property held by the corporation.

For purposes of applying the anti-transfer rules in the percentage depletion provisions, the subchapter S corporation will be treated as a partnership and the shareholders will be treated as partners. Similarly, an election by a regular corporation to become a subchapter S corporation will be treated as a transfer of all the property of the corporation effective on the day on which the election takes effect. Finally, for purposes of the anti-transfer rules, the termination of a subchapter S election and the reversion to regular status will be treated as a transfer by the shareholders of all the assets of the subchapter S corporation to the regular corporation.

For purposes of the windfall profit tax, a subchapter S corporation will be treated as a partnership. Specifically, any subchapter S corporation which would otherwise be treated as a producer of crude oil will

not be so treated; instead, all the crude oil produced by that corporation will be allocated among the shareholders in proportion to each shareholder's pro rata share of the income of the corporation. Each shareholder entitled to an allocation of crude oil will be treated as the producer of that crude oil for purposes of the windfall profit tax. Thus, for purposes of the independent producer lower rates (including the anti-transfer rules), the subchapter S corporation will be treated as a partnership and the shareholders of the subchapter S corporation will be treated as partners of a partnership.

3. Treatment of expenses owed to shareholders

Present Law

Under present law, a subchapter C corporation, in order to obtain a deduction for business expenses or interest payable to a cash-basis shareholder owning (after application of the constructive ownership rules of sec. 267(c)) more than 50 percent of the stock of the corporation, must actually pay such items not later than 2½ months after the close of its taxable year. If the shareholder owns 50 percent or less of the stock, a subchapter S corporation on the accrual method of accounting may accrue the deduction (to the extent otherwise allowable) notwithstanding that the shareholder does not include the amount in income until actually paid.

Explanation of Provision (sec. 267)

The bill places a subchapter S corporation on the cash method of accounting for purposes of deducting business expenses and interest owed to a cash-basis shareholder who owns at least two percent of the stock in the corporation. Thus, the timing of the corporation's deductions (which are taken into account on the shareholders' returns) and the shareholder's income will match. Also, no deductions will be lost if payment is made after 2½-month period expires.

The usual loss disallowance rules (of sec. 267) will apply to transactions (to which the new rule of section 267(f) does not apply) between two subchapter S corporations, or between a subchapter S corporation and a partnership, if both entities are more than 50 percent owned by the same persons. Also a subchapter S corporation and a regular operation are treated as related if the same individual owns more than 50 percent of the value of the outstanding stock in each corporation.

G. Tax Administration Provisions

Present Law

Under present law, a taxpayer's individual tax liability is determined in proceedings between the Internal Revenue Service and the individual whose tax liability is in dispute. Thus, any issues involving the income or deductions of a subchapter S corporation are determined separately in administrative or judicial proceedings involving the individual shareholder whose tax liability is affected. Statutes of limitations apply at the individual level, based on the returns filed by the individual. The filing by the corporation of its return does not affect the statute of limitations applicable to the shareholders.

Explanation of Provision (secs. 6241–6245)

Under the bill, the tax treatment of items of subchapter S income, loss, deductions, and credits generally will be determined at the corporate level in a unified proceeding rather than in separate proceedings with shareholders. Shareholders will be given notice of any administrative or judicial proceeding at which such items will be determined. Further, each shareholder will be given the opportunity to participate in these proceedings. Shareholders will be required to file returns consistent with the corporate return or notify the Internal Revenue Service of the inconsistency.

The audit provisions are to generally follow the new audit provisions made applicable to partnerships by the Tax Equity and Fiscal Responsibility Act of 1982. Thus, for example, rules relating to restrictions on assessing deficiencies, periods of limitations, and judicial review will follow the corresponding partnership rules. However, those rules may be modified by Treasury regulations where appropriate to take account of the differences (whether or not tax related) between a corporation and a partnership. For example, the selection of a person to act on behalf of the corporation in the way the tax matters partner acts on behalf of a partnership must take into account that a corporation has no person to correspond to a general partner, as such (since the corporate shareholders are not liable for the corporation's debts, as is a general partner). As with partnerships, the regulations may treat certain corporate items as other than corporate items, for purposes of these audit rules, where special enforcement problems arise.

H. Effective Date and Transitional Rules (sec. 1379)

The bill will apply to taxable years beginning after December 31, 1982. Existing subchapter S corporations will be treated under the new rules for the first taxable year beginning after that date. Pre-enactment undistributed taxable income and previously taxed income of these corporations can be distributed in the future under the rules of present law. Carryforwards, such as capital loss carryforwards and charitable contribution carryovers from the corporation's last pre-enactment year shall be treated as sustained in it's first post-enactment year.

The present rules of section 1379, relating to pension and profit-sharing plans, will continue in effect for years beginning before 1984. Also the amendment relating to certain death benefit payments made by section 239 of the Tax Equity and Fiscal Responsibility Act of 1982 will apply, in the case of subchapter S corporations, after 1982.

Finally, the amendments to subchapter S made by the bill will not apply to a casualty insurance company described in section 831 (a) if either (1) the corporation was a subchapter S casualty insurance company on July 12, 1982, (2) the corporation was formed prior to April 1, 1982, and proposed, through a written private offering first circulated to investors prior to that date, to elect to be taxed as a subchapter S corporation and to be operated on an established insurance exchange; or (3) the corporation is approved for membership on an established insurance exchange pursuant to a written agreement entered into before December 31, 1982, and the corporation is engaged in the casualty insurance business before the end of 1984. These corporations will continue under present subchapter S rules until either the subchapter S election is terminated, or more than one-half the stock ceases (other than by reason of death) to be held by persons holding the stock on December 31, 1984.

IV. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

Budget Effects

In compliance with clause 7 of Rule XIII of the Rules of the House of Representatives, the following statement is made about the effect on the budget of this bill, H.R. 6055. The committee estimates that the provisions contained in the bill, H.R. 6055, as amended, will reduce budget receipts by less than $10 million annually.

The Treasury Department agrees with this statement.

Vote of the Committee

In compliance with clause 2(l)(2)(B) of Rule XI of the Rules of the House of Representatives, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 6055, as amended, was ordered favorably reported by voice vote.

V. OTHER MATTERS TO BE DISCUSSED UNDER HOUSE RULES

In compliance with clauses 3(l)(3) and 2(l)(4) of Rule XI of the Rules of the House of Representatives, the following statements are made with respect to the committee action on H.R. 6055, as amended.

Oversight Findings

With respect to subdivision (A) of clause 2(l)(3) (relating to oversight findings), the committee advises that it was as a result of the committee's oversight activities with respect to the application of the provisions of Subchapter S of the Internal Revenue Code of 1954 that the committee concluded that it is appropriate to enact the provisions contained in the bill.

The Subcommittee on Select Revenue Measures held a hearing on June 14, 1982, and ordered the bill favorably reported by voice vote to the full committee, with amendments, on July 12, 1982. The Subcommittee transmitted a report to the full committee on July 15, 1982.

New Budget Authority and Tax Expenditures

With respect to subdivision (B) of clause 2(l)(3), after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new budget authority or new or increased tax expenditures.

Consultation with Congressional Budget Officials on Budget Estimates

With respect to subdivision (C) of clause 2(l)(3), the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated in part IV of this report) and agrees with the budget estimate.

Oversight by Committee on Government Operations

With respect to subdivision (D) of clause 2(l)(3), the committee advises that no oversight findings or recommendations have been submitted to the committee by the Committee on Government Operations regarding the subject matter of this bill.

Inflationary Impact

In compliance with clause 2(l)(4), the committee states that the enactment of this bill is not expected to have an inflationary impact on prices and costs in the operation of the national economy.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman) :

INTERNAL REVENUE CODE OF 1954

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Subtitle A—Income Taxes

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CHAPTER 1—NORMAL TAXES AND SURTAXES

SUBCHAPTER A. Determination of tax liability.
SUBCHAPTER B. Computation of taxable income.
SUBCHAPTER C. Corporate distributions and adjustments.
SUBCHAPTER D. Deferred compensation, etc.
SUBCHAPTER E. Accounting periods and methods of accounting.
SUBCHAPTER F. Exempt organizations.
SUBCHAPTER G. Corporations used to avoid income tax on shareholders.
SUBCHAPTER H. Banking institutions.
SUBCHAPTER I. Natural resources.
SUBCHAPTER J. Estates, trusts, beneficiaries, and decedents.
SUBCHAPTER K. Partners and partnerships.
SUBCHAPTER L. Insurance companies.
SUBCHAPTER M. Regulated investment companies and real estate investment trusts.
SUBCHAPTER N. Tax based on income from sources within or without the United States.
SUBCHAPTER O. Gain or loss on disposition of property.
SUBCHAPTER P. Capital gains and losses.
SUBCHAPTER Q. Readjustment of tax between years and special limitations.
[SUBCHAPTER S. Election of certain small business corporations as to taxable status.]
SUBCHAPTER S. Tax treatment of S corporations and their shareholders.
SUBCHAPTER T. Cooperatives and their patrons.
SUBCHAPTER U. General stock ownership corporations.
SUBCHAPTER V. Title II cases.

Subchapter A—Determination of Tax Liability

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PART IV—CREDITS AGAINST TAX

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Subpart A—Credits Allowable

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SEC. 31. TAX WITHHELD ON WAGES, INTEREST, DIVIDENDS, AND PATRONAGE DIVIDENDS.

(a) WAGE WITHHOLDING.— * * *

* * * * * * *

[(d) YEAR FOR WHICH CREDIT ALLOWED.—

[(1) IN GENERAL.—Except as otherwise provided in paragraph (2), any credit allowed by this section shall be allowed for the taxable year beginning in the calendar year in which the amount was withheld (or, in the case of subsection (c), in which the wages were received). If more than 1 taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

[(2) SPECIAL RULE FOR CERTAIN DISTRIBUTIONS OF SUBCHAPTER S CORPORATIONS.—The amount withheld with respect to a distribution by an electing small business corporation (within the meaning of section 1371(b)) which is treated as a distribution of such corporation's undistributed taxable income for the preceding year under section 1375(f)(1) shall be allowed as a credit for the taxable year of the recipient beginning in the calendar year in which the preceding year of the corporation ends.]

(d) YEAR FOR WHICH CREDIT ALLOWED.—Any credit allowed by this section shall be allowed for the taxable year beginning in the taxable year in which the amount was withheld (or, in the case of subsection (c). in which the wages were received). If more than 1 taxable year begins in a calendar year, such amount shall be allowed as a credit for the last taxable year so beginning.

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SEC. 44D. CREDIT FOR PRODUCING FUEL FROM A NONCONVENTIONAL SOURCE.

(a) ALLOWANCE OF CREDIT.—* * *

* * * * * * *

(d) OTHER DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) ONLY PRODUCTION WITHIN THE UNITED STATES TAKEN INTO ACCOUNT.—* * *

* * * * * * *

[(9) PASS-THROUGH IN THE CASE OF SUBCHAPTER S CORPORATIONS, ETC.—Under regulations prescribed by the Secretary, rules similar to the rules of subsections (d) and (e) of section 52 shall apply.]

(9) PASS-THRU IN THE CASE OF ESTATES AND TRUSTS.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply.

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SEC. 44E. ALCOHOL USED AS FUEL.

(a) GENERAL RULE.—There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to the sum of—

(1) the alcohol mixture credit, plus

(2) the alcohol credit.

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(d) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) ALCOHOL DEFINED.—* * *

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[(5) PASS-THROUGH IN THE CASE OF SUBCHAPTER S CORPORATIONS, ETC.—Under regulations prescribed by the Secretary, rules similar to the rules of subsections (d) and (e) of section 52 shall apply.]

(5) PASS-THRU IN THE CASE OF ESTATES AND TRUSTS.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply.

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SEC. 44F. CREDIT FOR INCREASING RESEARCH ACTIVITIES.

(a) GENERAL RULE.— * * *

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(f) SPECIAL RULES.—For purposes of this section—

(1) AGGREGATION OF EXPENDITURES.—

(A) CONTROLLED GROUP OF CORPORATIONS.—In determining the amount of the credit under this section—

(i) all members of the same controlled group of corporations shall be treated as a single taxpayer, and

(ii) the credit (if any) allowable by this section to each such member shall be its proportionate share of the increase in qualified research expenses giving rise to the credit.

(B) COMMON CONTROL.—Under regulations prescribed by the Secretary, in determining the amount of the credit under this section—

(i) all trades or businesses (whether or not incorporated) which are under common control shall be treated as a single taxpayer, and

(ii) the credit (if any) allowable by this section to each such person shall be its proportionate share of the increase in qualified research expenses giving rise to the credit.

The regulations prescribed under this subparagraph shall be based on principles similar to the principles which apply in the case of subparagraph (A).

(2) ALLOCATIONS.—

[(A) PASSTHROUGH IN THE CASE OF SUBCHAPTER S CORPORATIONS, ETC.—Under regulations prescribed by the Secretary, rules similar to the rules of subsections (d) and (e) of section 52 shall apply.]

(A) PASS-THRU IN THE CASE OF ESTATES AND TRUSTS.—Under regulations prescribed by the Secretary, rules similar to the rules of subsection (d) of section 52 shall apply.

* * * * * * *

(g) LIMITATION BASED ON AMOUNT OF TAX.—

(1) LIABILITY FOR TAX.—

(A) IN GENERAL.—Except as provided in subparagraph (B), the credit allowed by subsection (a) for any taxable year shall not exceed the amount of the tax imposed by this

chapter reduced by the sum of the credits allowable under a section of this part having a lower number or letter designation than this section, other than the credits allowable by sections 31, 39, and 43. For purposes of the preceding sentence, the term "tax imposed by this chapter" shall not include any tax treated as not imposed by this chapter under the last sentence of section 53(a).

(B) SPECIAL RULE FOR PASSTHROUGH OF CREDIT.—In the case of an individual who—

(i) owns an interest in an unincorporated trade or business,

(ii) is a partner in a partnership,

(iii) is a beneficiary of an estate or trust, or

(iv) is a shareholder in [an electing small business corporation (within the meaning of section 1371(b)] *an S corporation*,

the credit allowed by subsection (a) for any taxable year shall not exceed the lesser of the amount determined under subparagraph (A) for the taxable year or an amount (separately computed with respect to such person's interest in such trade or business or entity) equal to the amount of tax attributable to that portion of a person's taxable income which is allocable or apportionable to the person's interest in such trade or business or entity.

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Subpart B—Rules for Computing Credit for Investment in Certain Depreciable Property

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SEC. 46. AMOUNT OF CREDIT.

(a) GENERAL RULE.

(1) FIRST-IN-FIRST-OUT RULE.—* * *

* * * * * * *

(4) LIABILITY FOR TAX.—For purposes of paragraph (3), the liability for tax for the taxable year shall be the tax imposed by this chapter for such year, reduced by the sum of the credits allowable under—

(A) section 33 (relating to foreign tax credit), and

(B) section 37 (relating to credit for the elderly).

For purposes of this paragraph, any tax imposed for the taxable year by section 56 (relating to minimum tax for tax preferences), section 72(m)(5)(B) relating to 10 percent tax on premature distributions to owner-employees), section 402(e) (relating to tax on lump sum distributions), section 408(f) (relating to additional tax on income from certain retirement accounts), section 531 (relating to accumulated earnings tax), section 541 (relating to personal holding company tax), or [section 1378 (relating to tax on certain capital gains of subchapter S corporations),] *section 1374 (relating to tax on certain capital gains of S corporations)*, and any additional tax imposed for the taxable year by section 1351

(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by this chapter for such year.

* * * * * * *

(c) QUALIFIED INVESTMENT.—
(1) IN GENERAL.—* * *

* * * * * * *

(8) LIMITATION TO AMOUNT AT RISK.—
(A) IN GENERAL.—* * *

* * * * * * *

(C) SPECIAL RULE FOR PARTNERSHIPS AND SUBCHAPTER S CORPORATIONS.—In the case of any partnership or [electing small business corporation (within the meaning of section 1371(b))] *S corporation* any amount treated as at risk under subparagraph (B)(ii) shall be allocated among the partners or shareholders (and treated as an amount at risk with respect to such persons) in the same manner as the credit allowable by section 38.

* * * * * * *

(e) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.—
(1) IN GENERAL.—* * *

* * * * * * *

(3) NONCORPORATE LESSORS.—A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if—

(A) the property subject to the lease has been manufactured or produced by the lessor, or

(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this paragraph. For purposes of this paragraph, [an electing small business corporation (as defined in section 1371)] *an S corporation* shall be treated as a person which is not a corporation. This paragraph shall not apply with respect to any property which is treated as section 38 property by reason of section 48(a)(1)(E). For purposes of subparagraph (B), in the case of any recovery property (within the meaning of section 168), the useful life shall be the present class life for such property (as defined in section 168(g)(2)).

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SEC. 48. DEFINITIONS; SPECIAL RULES.

(a) SECTION 38 PROPERTY.—* * *

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(c) USED SECTION 38 PROPERTY.—

(1) IN GENERAL.—* * *

(2) DOLLAR LIMITATION.—

(A) IN GENERAL.—* * *

* * * * * * *

(D) PARTNERSHIPS *AND S CORPORATIONS.*—In the case of a partnership, the limitation contained in subparagraph (A) shall apply with respect to the partnership and with respect to each partner. *A similar rule shall apply in the case of an S corporation and its shareholders.*

* * * * * * *

[(e) SUBCHAPTER S CORPORATIONS.—In the case of an electing small business corporation (as defined in section 1371)—

[(1) the qualified investment for each taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such taxable year; and

[(2) any person to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by means of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be.]

* * * * * * *

(k) MOVIE AND TELEVISION FILMS.—

(1) ENTITLEMENT TO CREDIT.—* * *

* * * * * * *

(5) QUALIFIED UNITED STATES PRODUCTION COSTS.—

(A) IN GENERAL.—* * *

* * * * * * *

(D) ALLOCATION OF DIRECT PRODUCTION COSTS.—For purposes of this paragraph—

(i) Compensation for services performed shall be allocated to the country in which the services are performed, except that payments to United States persons for services performed outside the United States shall be allocated to the United States. For purposes of the preceding sentence, payments to [an electing small business corporation (within the meaning of section 1371)] *an S corporation* or a partnership shall be considered payments to a United States person only to the extent that such payments are included in the gross income of a United States person other than an electing small business corporation or partnership.

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Subpart C—Rules for Computing Credit for Expenses of Work Incentive Programs

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SEC. 50A. AMOUNT OF CREDIT.

(a) DETERMINATION OF AMOUNT.—

(1) GENERAL RULE.—* * *

* * * * * * *

(3) LIABILITY FOR TAX.—For purposes of paragraph (2), the liability for tax for the taxable year shall be the tax imposed by this chapter for such year, reduced by the sum of the credits allowable under—

(A) section 33 (relating to foreign tax credit).

(B) section 37 (relating to credit for the elderly),

(C) section 38 (relating to investment in certain depreciable property), and

(D) section 41 (relating to contributions to candidates for public office).

For purposes of this paragraph, any tax imposed for the taxable year by section 56 (relating to minimum tax for tax preferences), section 72(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees), section 402(e) (relating to tax on lump sum distributions), section 408(f) (relating to additional tax on income from certain retirement accounts), section 531 (relating to accumulated earnings tax), section 541 (relating to personal holding company tax), or [section 1378 (relating to tax on certain capital gains of subchapter S corporations),] *section 1374 (relating to tax on certain capital gains of S corporations*), and any additional tax imposed for the taxable year by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by this chapter for such year.

* * * * * * *

SEC. 50B. DEFINITIONS; SPECIAL RULES.

(a) WORK INCENTIVE PROGRAM EXPENSES.—* * *

* * * * * * *

[(d) SUBCHAPTER S CORPORATIONS.—In case of an electing small business corporation (as defined in section 1371)—

[(1) the work incentive program expenses for each taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such taxable year, and

[(2) any person to whom any expenses have been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such expenses.]

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Subpart D—Rules for Computing Credit for Employment of Certain New Employees

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SEC. 52. SPECIAL RULES.

(a) CONTROLLED GROUP OF CORPORATIONS.—* * *

* * * * * * *

[(d) SUBCHAPTER S CORPORATIONS.—In the case of an electing small business corporation (as defined in section 1371)—

[(1) the amount of the credit determined under this subpart for any taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such taxable year, and

[(2) any person to whom an amount is apportioned under paragraph (1) shall be allowed, subject to section 53, a credit under section 44B for such amount.]

[(e)] (*d*) ESTATES AND TRUSTS.—In the case of an estate or trust—

(1) the amount of the credit determined under this subpart for any taxable year shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each, and

(2) any beneficiary to whom any amount has been apportioned under paragraph (1) shall be allowed, subject to section 53, a credit under section 44B for such amount.

[(f)] (*e*) LIMITATIONS WITH RESPECT TO CERTAIN PERSON.—Under regulations prescribed by the Secretary, in the case of—

(1) an organization to which section 593 (relating to reserves for losses on loans) applies,

(2) a regulated investment company or a real estate investment trust subject to taxation under subchapter M (section 851 and following), and

(3) a cooperative organization described in section 1381(a), rules similar to the rules provided in subsections (e) and (h) of section 46 shall apply in determining the amount of the credit under this subpart.

SEC. 53. LIMITATION BASED ON AMOUNT OF TAX.

(a) GENERAL RULE.—Notwithstanding section 51, the amount of the credit allowed by section 44B for the taxable year shall not exceed 90 percent of the excess of the tax imposed by this chapter for the taxable year over the sum of the credits allowable under—

(1) section 33 (relating to foreign tax credit),

(2) section 37 (relating to credit for the elderly),

(3) section 38 (relating to investment in certain depreciable property),

(4) section 40 (relating to expenses of work incentive programs),

(5) section 41 (relating to contributions to candidates for public office),

(6) section 42 (relating to general tax credit), and

(7) section 44A (relating to expenses for household and dependent care services necessary for gainful employment.)

For purposes of this subsection, any tax imposed for the taxable year by section 56 (relating to minimum tax for tax preferences), section 72

(m)(5)(B) (relating to 10 percent tax on premature distributions to owner-employees), section 408(f) (relating to additional tax on income from certain retirement accounts), section 402(e) (relating to tax on lump-sum distributions), section 531 (relating to accumulated earnings tax), section 541 (relating to personal holding company tax), or [section 1378 (relating to tax on certain capital gains of subchapter S corporations)] *section 1374 (relating to tax on certain capital gains of S corporations)*, and any additional tax imposed for the taxable year by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by this chapter for such year.

* * * * * * *

PART VI—MINIMUM TAX FOR TAX PREFERENCES

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SEC. 55. ALTERNATIVE MINIMUM TAX FOR TAXPAYERS OTHER THAN CORPORATIONS.

(a) TAX IMPOSED.—* * *

* * * * * * *

(e) ALTERNATIVE TAX ITEMIZED DEDUCTIONS.—For purposes of this section—

(1) IN GENERAL.—* * *

* * * * * * *

(8) TREATMENT OF INTERESTS IN LIMITED PARTNERSHIPS AND SUBCHAPTERS CORPORATIONS.—

(A) CERTAIN INTEREST TREATED AS NOT ALLOWABLE IN COMPUTING ADJUSTED GROSS INCOME.—Any amount allowable as a deduction for interest on indebtedness incurred or continued to purchase or carry a limited business interest shall be treated as not allowable in computing adjusted gross income.

(B) INCOME TREATED AS QUALIFIED INVESTMENT INCOME.—Any income derived from a limited business interest shall be treated as qualified investment income.

(C) LIMITED BUSINESS INTEREST.—The term "limited business interest" means an interest—

(i) as a limited partner in a partnership, or

(ii) as a shareholder in [an electing small business corporation (as defined in section 1371(b))] *an S corporation* if the taxpayer does not actively participate in the management of such corporation.

* * * * * * *

SEC. 57. ITEMS OF TAX PREFERENCE.

(a) IN GENERAL.—For purposes of this part, the items of tax preference are—

(1) ADJUSTED ITEMIZED DEDUCTIONS.—* * *

* * * * * * *

(12) ACCELERATED COST RECOVERY DEDUCTION.—

(A) IN GENERAL.—With respect to each recovery property (other than 15-year real property) whch is subject to a lease,

the amount (if any) by which the deduction allowed under section 168(a) for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated using the straight-line method (with a half-year convention and without regard to salvage value) and a recovery period determined in accordance with the following table:

In the case of:	The recovery period is:
3-year property	5 years.
5-year property	8 years.
10-year property	15 years.
15-year public utility property	22 years.

(B) 15-YEAR REAL PROPERTY.—With respect to each recovery property which is 15-year real property, the amount (if any) by which the deduction allowed under section 168(a) for the taxable year exceeds the deduction which would have been allowable for the taxable year had the property been depreciated using a 15-year period and the straight-line method (without regard to salvage value).

(C) PARAGRAPHS (2) AND (3) SHALL NOT APPLY.—Paragraphs (2) and (3) shall not apply to recovery property.

(D) DEFINITIONS.—For purposes of this paragraph, the terms "3-year property", "5-year property", "10-year property", "15-year public utility property", "15-year real property", and "recovery property", shall have the same meanings given such terms under section 168.

Paragraphs (3), (11), and (12) shall not apply to a corporation other than [an electing small business corporation (as defined in section 1371 (b)) and] a personal holding company (as defined in section 542). For purposes of section 56, in the case of a taxpayer other than a corporation, the adjusted itemized deductions described in paragraph (1) and capital gains described in paragraph (9) shall not be treated as items of tax preference.

(b) APPLICATION WITH SECTION 291.—

(1) IN GENERAL.—In the case of any item of tax preference of [an applicable corporation] *a corporation* described in—

(A) paragraph (4) or (7) of subsection (a), or

(B) paragraph (8) of subsection (a) (but only to the extent such item is allocable to a deduction for depletion for iron ore and coal including lignite)),

only 71.6 percent of the amount of such item of tax preference (determined without regard to this subsection) shall be taken into account as an item of tax preference.

(2) CERTAIN CAPITAL GAINS.—In determining the net capital gain of any [applicable] corporation for purposes of paragraph (9)(B) of subsection (a), there shall be taken into account only 71.6 percent of any gain from the sale or exchange of section 1250 property which is equal to 85 percent of the excess determined under section 291(a)(1) with respect to such property.

[(3) APPLICABLE CORPORATION DEFINED.—For purposes of this subsection, the term "applicable corporation" has the meaning given such term by section 291(e)(2).]

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SEC. 58. RULES FOR APPLICATION OF THIS PART

(a) MARRIED INDIVIDUALS FILING SEPARATE RETURNS.—

* * * * * * *

[(d) ELECTING SMALL BUSINESS CORPORATIONS AND THEIR SHAREHOLDERS.—

(1) IN GENERAL.—Except as provided in paragraph (2), the items of tax preference of an electing small business corporation (as defined in section 1371(b)) for each taxable year of the corporation, and, except as provided in paragraph (2), shall not be treated as items of tax preference of such corporation. The sum of the items so treated shall be apportioned pro rata among such shareholders in a manner consistent with section 1374(c)(1). For purposes of this paragraph, this part shall be treated as applying to such corporation.

[(2) CERTAIN CAPITAL GAINS.—If for a taxable year of an electing small business corporation a tax is imposed on the income of such corporation under section 1378, such corporation shall be subject to the tax imposed by section 56, but computed only with reference to the item of tax preference set forth in section 57(a)(9)(B) to the extent attributable to gains subject to the tax imposed by section 1378.]

(d) CERTAIN CAPITAL GAINS OF S CORPORATIONS.—If for a taxable year of an S corporation a tax is imposed on the income of such corporation under section 1374, such corporation shall be subject to the tax imposed by section 56, but computed only with reference to the item of tax preference set forth in section 57(a)(9)(B) to the extent attributable to gains subject to the tax imposed by section 1374.

* * * * * * *

(i) OPTIONAL 10-YEAR WRITEOFF OF CERTAIN TAX PREFERENCES.—

(1) IN GENERAL.—For purposes of this title, in the case of an individual, any qualified expenditure to which an election under this paragraph applies shall be allowed as a deduction ratably over the 10-year period beginning with the taxable year in which such expenditure was made.

(2) QUALIFIED EXPENDITURE.—For purposes of this subsection, the term "qualified expenditure" means any amount which, but for an election under this subsection, would have been allowable as a deduction for the taxable year in which paid or incurred under—

(A) section 173 (relating to circulation expenditures),

(B) section 174(a) (relating to research and experimental expenditures),

velopment expenditures),

(C) section 263(c) (relating to intangible drilling and development expenditures,

(D) section 616(a) (relating to development expenditures), or

(E) section 617 (relating to deduction of certain mining exploration expenditures).

(3) OTHER SECTIONS NOT APPLICABLE.—Except as provided in this subsection, no deduction shall be allowed under any other section for any qualified expenditure to which an election under this subsection applies.

(4) SPECIAL ELECTION FOR INTANGIBLE DRILLING AND DEVELOPMENT COSTS NOT ALLOCABLE TO [INTEREST AS LIMITED PARTNER] *LIMITED BUSINESS INTEREST.*—

(A) IN GENERAL.—In the case of any nonlimited partnership intangible drilling costs to which an election under this paragraph applies—

(i) the applicable percentage of such costs (adjusted as provided in section 48(q)) shall be allowed as a deduction for the taxable year in which paid or incurred and for each of the 4 succeeding taxable years, and

(ii) such costs shall be treated, for purposes of determining the amount of the credit allowable under section 38 for the taxable year in which paid or incurred, as qualified investment (within the meaning of subsections (c) and (d) of section 46) with respect to property placed in service during such year.

(B) APPLICABLE PERCENTAGE.—For purposes of subparagraph (A), the term "applicable percentage" means the percentage determined in accordance with the following table:

Taxable Year:	Applicable percentage:
1	15
2	22
3	21
4	21
5	21

[(C) NONLIMITED PARTNERSHIP INTANGIBLE DRILLING COSTS.—For purposes of this paragraph, the term "nonlimited partnership intangible drilling costs" means any qualified expenditure described in paragraph (2)(C) of an individual which is not allocable to such individual's interest as a limited partner in a limited partnership.]

(C) NONLIMITED INTANGIBLE DRILLING COSTS.—For purposes of this paragraph, the term "nonlimited intangible drilling costs" means any qualified expenditure described in paragraph (2)(C) of an individual which is not allocable to a limited business interest (as defined in section 55(e)(8)(C)) of such individual.

(5) ELECTION.—

(A) IN GENERAL.—An election may be made under this subsection with respect to any qualified expenditure.

(B) REVOCABLE ONLY WITH CONSENT.—An election under this subsection with respect to any qualified expenditure may be revoked only with the consent of the Secretary.

(C) TIME AND MANNER.—An election under this subsection shall be made at such time and in such manner as the Secretary shall by regulations prescribe.

(D) PARTNERS *AND SHAREHOLDERS OF S CORPORATIONS.*—In the case of a partnership, any election under this subsection shall be made separately by each partner with respect to the partner's allocable share of any qualified expenditure. *A similar rule shall apply in the case of an S corporation and its shareholders.*

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Subchapter B—Computation of Taxable Income

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PART I—DEFINITION OF GROSS INCOME, ADJUSTED GROSS INCOME, TAXABLE INCOME, ETC.

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SEC. 62. ADJUSTED GROSS INCOME DEFINED.

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) TRADE AND BUSINESS DEDUCTIONS.—The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

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[(9) PENSION, ETC., PLANS OF ELECTING SMALL BUSINESS CORPORATIONS.—The deduction allowed by section 1379(b)(3).]

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PART III—ITEMS SPECIFICALLY EXCLUDED FROM GROSS INCOME

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SEC. 108. INCOME FROM DISCHARGE OF INDEBTEDNESS.

(a) EXCLUSION FROM GROSS INCOME.—* * *

* * * * * * *

(d) MEANING OF TERMS; SPECIAL RULES RELATING TO SUBSECTIONS (a), (b), AND (c).—

(1) INDEBTEDNESS OF TAXPAYER.—For purposes of this section, the term "indebtedness of the taxpayer" means any indebtedness—

(A) for which the taxpayer is liable, or

(B) subject to which the taxpayer holds property.

* * * * * * *

[(6) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT PARTNER LEVEL.—In the case of a partnership, subsections (a), (b), and (c) shall be applied at the partner level.]

(6) SUBSECTIONS (a), (b), AND (c) TO BE APPLIED AT PARTNER LEVEL OR S CORPORATION SHAREHOLDER LEVEL.—In the case of a partnership, subsections (a), (b), and (c) shall be applied at the partner level. In the case of an S corporation, subsections (a), (b), and (c) shall be applied at the shareholder level.

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PART VI—ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

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SEC. 163. INTEREST.

(a) GENERAL RULE.—* * *

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(d) LIMITATION ON INTEREST ON INVESTMENT INDEBTEDNESS.—
(1) IN GENERAL.—* * *

* * * * * * *

(4) SPECIAL RULES.—

(A) PROPERTY SUBJECT TO NET LEASE.—*For purposes of this* subsection, property subject to a lease shall be treated as property held for investment, and not as property used in a trade or business, for a taxable year, if—

(i) for such taxable year the sum of the deductions of the lessor with respect to such property which are allowable solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) is less than 15 percent of the rental income produced by such property, or

(ii) the lessor is either guaranteed a specified return or is guaranteed in whole or in part against loss of income.

(B) PARTNERSHIPS.—In the case of a partnership, each partner shall, under regulations prescribed by the Secretary, take into account separately his distributive share of the partnership's investment interest and the other items of income and expense taken into account under this subsection.

[(C) SHAREHOLDERS OF ELECTING SMALL BUSINESS CORPORATIONS.—In the case of an electing small business corporation (as defined in section 1371(b)), the investment interest paid or accrued by such corporation and the other items of income and expense which would be taken into account if this subsection applied to such corporation shall, under regulations prescribed by the Secretary, be treated as investment interest paid or accrued by the shareholders of such corporation and as items of such shareholders, and shall be apportioned pro rata among such shareholders in a manner consistent with section 1374(c)(1).]

[(D)] *(B)* CONSTRUCTION INTEREST.—For purposes of this subsection, interest paid or accrued on indebtedness incurred or continued in the construction of property to be used in a trade or business shall not be treated as investment interest.

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SEC. 168. ACCELERATED COST RECOVERY SYSTEM.

(a) ALLOWANCE OF DEDUCTION.—* * *

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(f) SPECIAL RULES FOR APPLICATION OF THIS SECTION.—For purposes of this section—

(1) COMPONENTS OF SECTION 1250 CLASS PROPERTY.—* * *

* * * * * * *

(8) SPECIAL RULE FOR LEASES.—

(A) IN GENERAL.—In the case of an agreement with respect to qualified leased property, if all the parties to the agreement characterize such agreement as a lease and elect to have the provisions of this paragraph apply with respect to such agreement, and if the requirements of subparagraph (B) are met, then, for purposes of this subtitle—

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(i) such agreement shall be treated as a lease entered into by the parties (and any party which is a corporation described in subparagraph (B)(i)(I) shall be deemed to have entered into the lease in the course of carrying on a trade or business), and

(ii) the lessor shall be treated as the owner of the property and the lessee shall be treated ast he lessee of the property.

(B) CERTAIN REQUIREMENTS MUST BE MET.—The requirements of this subparagraph are met if—

(i) the lessor is—

(I) a corporation (other than [an electing small business corporation (within the meaning of section 1371 (b))] *an S corporation* or a personal holding company (within the meaning of section 542(a)),

(II) a partnership all of the partners of which are corporations described in subclause (I), or

(III) a grantor trust with respect to which the grantor and all beneficiaries of the trust are described in subclause (I) or (II),

(ii) them inimum investment of the lessor —

(I) at the time the property is first placed in service under the lease, and

(II) at all times during the term of the lease,

is not less than 10 percent of the adjusted basis of such property, and

(iii) the term of the lease (including any extensions) does not exceed the greater of—

(I) 90 percent of the useful life of such property for purposes of section 167, or

(II) 150 percent of the present class life of such property.

* * * * * * *

(C) AGREEMENTS MUST MEET CERTAIN REQUIREMENTS.—The requirements of this subparagraph are met with respect to any agreement if—

(i) LESSOR REQUIREMENT.—Any lessor under the agreement must be—

(I) a corporation (other than [an electing small business corporation within the meaning of section 1371(b)] *an S corporation* or a personal holding company within the meaning of section 542(a)),

(II) a partnership all of the partners of which are corporations described in subclause (I), or

(III) a grantor trust with respect to which the grantor and all the beneficiaries of the trust are described in subclause (I) or (II).

(ii) CHARACTERIZATION OF AGREEMENT.—The parties to the agreement characterize such agreement as a lease.

(iii) AGREEMENT CONTAINS CERTAIN PROVISIONS.—The agreement contains the provision described in clause (i) or (ii) of subparagraph (A), or both.

(iv) AGREEMENT OTHERWISE LEASE, ETC.—For purposes of this title (determined without regard to the provisions described in clause (iii)), the agreement would be treated as a lease and the lessor under the agreement would be treated as the owner of the property.

* * * * * * *

SEC. 170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS.

(a) ALLOWANCE OF DEDUCTION.—* * *

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(e) CERTAIN CONTRIBUTIONS OF ORDINARY INCOME AND CAPITAL GAIN PROPERTY.—

(1) GENERAL RULE.—* * *

* * * * * * *

(3) SPECIAL RULE FOR CERTAIN CONTRIBUTIONS OF INVENTORY AND OTHER PROPERTY.—

(A) QUALIFIED CONTRIBUTIONS.—For purposes of this paragraph, a qualified contribution shall mean a charitable contribution of property described in paragraph (1) or (2) of section 1221, by a corporation (other than a corporation which is [an electing small business corporation within the meaning of section 1371(b))] *an S corporation*) to an organization which is described in section 501(c)(3) and is exempt under section 501(a) (other than a private foundation, as defined in section 509(a), which is not an operating foundation, as defined in section 4942(j)(3)), but only if—

(i) the use of the property by the donee is related to the purpose or function constituting the basis for its exemption under section 501 and the property is to be used by the donee solely for the care of the ill, the needy, or infants;

(ii) the property is not transferred by the donee in exchange for money, other property, or services;

(iii) the taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of clauses (i) and (ii); and

(iv) in the case where the property is subject to regulation under the Federal Food, Drug, and Cosmetic Act, as amended, such property must fully satisfy the applicable requirements of such Act and regulations promulgated thereunder on the date of transfer and for one hundred and eighty days prior thereto.

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(4) SPECIAL RULE FOR CONTRIBUTIONS OF SCIENTIFIC PROPERTY USED FOR RESEARCH.—

(A) LIMIT ON REDUCTION.— * * *

* * * * * * *

(D) CORPORATION.—For purposes of this paragraph, the term "corporation" shall not include—

(i) an electing small business corporation (as defined in section 1371(b)),]
(i) an S corporation;

* * * * * * *

SEC. 172. NET OPERATING LOSS DEDUCTION.

(a) DEDUCTION ALLOWED.—There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of (1) the net operating loss carryovers to such year, plus (2) the net operating loss carrybacks to such year. For purposes of this subtitle, the term "net operating loss deduction" means the deduction allowed by this subsection.

* * * * * * *

[(f) DISALLOWANCE OF NET OPERATING LOSS OF ELECTING SMALL BUSINESS CORPORATIONS.—In determining the amounts of the net operating loss deduction under subsection (a) of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S.]

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SEC. 179. ELECTION TO EXPENSE CERTAIN DEPRECIABLE BUSINESS ASSETS.

(a) TREATMENT AS EXPENSES.— * * *

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(d) DEFINITIONS AND SPECIAL RULES.—

(1) SECTION 179 PROPERTY.—For purposes of this section, the term "section 179 property" means any recovery property which is section 38 property and which is acquired by purchase for use in a trade or business

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(8) DOLLAR LIMITATION IN CASE OF PARTNERSHIPS *and S corporations.*—In the case of a partnership, the dollar limitation contained in subsection (b)(1) shall apply with respect to the partnership and with respect to each partner. *A similar rule shall apply in the case of an S corporation and its shareholders.*

* * * * * * *

SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT.

(a) GENERAL RULE.—In the case of an activity engaged in by an individual or [an electing small business corporation (as defined in section 1371(b))] *an S corporation*, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

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SEC. 189. AMORTIZATION OF REAL PROPERTY CONSTRUCTION PERIOD INTEREST AND TAXES.

(a) CAPITALIZATION OF CONSTRUCTION PERIOD INTEREST AND TAXES.—* * *

* * * * * * *

(d) CERTAIN PROPERTY EXCLUDED.—This section shall not apply to any—

(1) low-income housing,

(2) residential real property (other than low income housing) acquired, constructed, or carried by a corporation other than [an electing small business corporation (within the meaning of section 1371(b))] *an S corporation* a personal holding company (within the meaning of section 542), or a foreign personal holding company (within the meaning of section 552), or

(3) real property acquired, constructed, or carried if such property is not, and cannot reasonably expected to be, held in a trade or business, or in an activity conducted for profit.

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SEC. 194. AMORTIZATION OF REFORMATION EXPENDITURES.

(a) ALLOWANCE OF DEDUCTION.—* * *

(b) LIMITATIONS.—* * *

(1) MAXIMUM DOLLAR AMOUNT.—* * *

(2) ALLOCATION OF DOLLAR LIMIT.—* * *

(A) CONTROLLED GROUP.—For purposes of applying the dollar limitation under paragraph (1)—

(i) all component members of a controlled group shall be treated as one taxpayer, and

(ii) the Secretary shall, under regulations prescribed by him, apportion such dollar limitation among the component members of such controlled group.

For purposes of the preceding sentence, the term "controlled group" has the meaning assigned to it by section 1563(a), except that the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in section 1563(a)(1).

(B) PARTNERSHIPS *AND S CORPORATIONS.*—In the case of a partnership, the dollar limitation contained in paragraph (1) shall apply with respect to the partnership and with respect to each partner, *A similar rule shall apply in the case of an S corporation and its shareholders.*

(3) SECTION NOT TO APPLY TO TRUSTS.—This section shall not apply to trusts.

(4) ESTATES.—The benefit of the deduction for amortization provided by this section shall be allowed to estates in the same manner as in the case of an individual. The allowable deduction shall be apportioned between the income beneficiary and the fiduciary under regulations prescribed by the Secretary. Any amount so apportioned to a beneficiary shall be taken into account for purposes of determining the amount allowable as a deduction under this section to such beneficiary.

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PART IX—ITEMS NOT DEDUCTIBLE

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SEC. 267. LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS

(a) DEDUCTIONS DISALLOWED.—* * *

(b) RELATIONSHIPS.—The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c)(4);

* * * * * * *

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust; [or]

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual[.]; *(10) An S corporation and a partnership if the same persons own—*

(A) more than 50 percent in value of the outstanding stock of the S corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(12) An S corporation and a C corporation, if the same individual owns more than 50 percent in value of the outstanding stock of each corporation.

* * * * * * *

(f) SPECIAL RULES FOR UNPAID EXPENSES AND INTEREST OF S CORPORATIONS.—

(1) IN GENERAL.—In the case of any amount paid or incurred by an S corporation, if—

(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

(B) at the close of the taxable year of the S corporation for which (but for this paragraph) the amount would be deductible under section 162, 212, or 163, both the S corporation and the person to whom the payment is to be paid are persons specified in one of the paragraphs of subsection (b),

then no deduction shall be allowed in respect of expenses otherwise deductible under section 162 or 212, or of interest otherwise deductible under section 163, before the day as of which the amount thereof is includible in the gross income of the person to whom the payment is made.

(2) CERTAIN SHAREHOLDERS, ETC., TREATED AS RELATED PERSONS.—For purposes of applying paragraph (1)—

(A) an S corporation,

(B) any person who owns, directly or indirectly, 2 percent or more in value of the outstanding stock of such corporation, and

(C) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)(A)) to a person described in subparagraph (B),

shall be treated as persons specified in a paragraph of subsection (b).

(3) SUBSECTION (a)(2) NOT TO APPLY.—Subsection (a)(2) shall not apply to any amount paid or incurred by an S corporation.

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SEC. 280. CERTAIN EXPENDITURES INCURRED IN PRODUCTION OF FILMS, BOOKS, RECORDS, OR SIMILAR PROPERTY.

(a) GENERAL RULE.—In the case of an individual, except in the case of production costs which are charged to capital account, amounts attributable to the production of a film, sound recording, book, or similar property which are otherwise deductible under this chapter shall be allowed as deductions only in accordance with the provisions of subsection (b). For purposes of this section, [an electing small business corporation (as defined in section 1371(b)),] *an S corporation*, a personal holding company (as defined in section 542), and a foreign personal holding company (as defined in section 552) shall be treated as an individual.

* * * * * * *

SEC. 280A. DISALLOWANCE OF CERTAIN EXPENSES IN CONNECTION WITH BUSINESS USE OF HOME RENTAL OF VACATION HOMES, ETC.

(a) GENERAL RULE.—Except as otherwise provided in this section, in the case of a taxpayer who is an individual or [an electing small business corporation.] *an S corporation*, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence.

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PART XI—SPECIAL RULES RELATING TO CORPORATE PREFERENCE ITEMS

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SEC. 291. SPECIAL RULES RELATING TO CORPORATE PREFERENCE ITEMS.

(a) 15-PERCENT REDUCTION IN CERTAIN PREFERENCE ITEMS, ETC.—For purposes of this subtitle, in the case of [an applicable] *a* corporation—

(1) SECTION 1250 CAPITAL GAIN TREATMENT.—In the case of section 1250 property which is disposed of during the taxable year, 15 percent of the excess (if any) of—

(A) the amount which would be treated as ordinary income if such property was section 1245 property or section 1245 recovery property, over

(B) the amount treated as ordinary income under section 1250,

shall be treated as gain which is ordinary income and shall be recognized notwithstanding any other provision of this title.

(2) REDUCTION IN PERCENTAGE DEPLETION.—In the case of iron ore and coal (including lignite), the amount allowable as a deduction under section 613 with respect to any property (as defined in section 614) shall be reduced by 15 percent of the amount of the excess (if any) of—

(A) the amount of the deduction allowable under section 613 for the taxable year (determined without regard to this paragraph), over

(B) the adjusted basis of the property at the close of the taxable year (determined without regard to the depletion deduction for the taxable year).

(3) CERTAIN FINANCIAL INSTITUTION PREFERENCE ITEMS.—The amount allowable as a deduction under this chapter (determined without regard to this section) with respect to any financial institution preference item shall be reduced by 15 percent.

(4) CERTAIN DEFERRED DISC INCOME.—If [an applicable] *a* corporation is a shareholder of a DISC, in the case of taxable years beginning after December 31, 1982, section 995(b)(1)(F)(i) shall be applied with respect to such corporation by substituting "57.5 percent" for "one-half".

(5) AMORTIZATION OF POLLUTION CONTROL FACILITIES.—If an election is made under section 169 with respect to any certified pollution control facility, the amortizable basis of such facility for purposes of such section shall be reduced by 15 percent.

(b) SPECIAL RULES FOR TREATMENT OF INTANGIBLE DRILLING COSTS AND MINERAL EXPLORATION AND DEVELOPMENT COSTS.—For purposes of this subtitle, in the case of [an applicable] *a* corporation—

(1) IN GENERAL.—The amount allowable as a deduction for any taxable year (determined without regard to this section)—

(A) under section 263(c) in the case of an integrated oil company, or

(B) under section 616(a) or 617,

shall be reduced by 15 percent.

(2) Special rule for amounts not allowable as deductions under paragraph (1).—

(A) INTANGIBLE DRILLING COSTS.—The amount not allowable as a deduction under section 263(c) for any taxable year by reason of paragraph (1) shall be allowable as a deduction ratably over the 36-month period beginning with the month in which the costs are paid or incurred.

(B) MINERAL EXPLORATION AND DEVELOPMENT COSTS.—In the case of any amount not allowable as a deduction under section 616(a) or 617 for any taxable year by reason of paragraph (1)—

(i) the applicable percentage of the amount not so allowable as a deduction shall be allowable as a deduction for the taxable year in which the costs are paid or incurred and in each of the 4 succeeding taxable years, and

(ii) such costs shall be treated, for purposes of determining the amount of the credit allowable under section 38 for the taxable year in which paid or incurred, as qualified investment (within the meaning of subsections (c)

and (d) of section 46) with respect to property placed in service during such year.

(3) APPLICABLE PERCENTAGE.—For purposes of paragraph (2)(B), the term "applicable percentage" means the percentage determined in accordance with the following table:

Taxable Year:	Applicable Percentage:
1	15
2	22
3	21
4	21
5	21

(4) DISPOSITIONS.—

(A) OIL, GAS, AND GEOTHERMAL PROPERTY.—In the case of any disposition of any oil, gas, or geothermal property to which section 1254 applies (determined without regard to this section) any deduction under paragraph (2)(A) with respect to intangible drilling and development costs under section 263(c) which are allocable to such property shall, for purposes of section 1254, be treated as a deduction allowable under section 263(c).

(B) APPLICATION OF SECTION 617(d).—In the case of any disposition of mining property to which section 617(d) applies (determined without regard to this section), any amount allowable as a deduction under paragraph (2)(B) which is allocable to such property shall, for purposes of section 617(d), be treated as a deduction allowable under section 617(a).

(C) RECAPTURE OF INVESTMENT CREDIT.—In the case of any disposition of any property to which the credit allowable under section 38 by reason of paragraph (2)(B) is allocable, such disposition shall, for purposes of section 47, be treated as a disposition of section 38 recovery property which is not 3-year property.

(5) INTEGRATED OIL COMPANY DEFINED.—For purposes of this subsection, the term "integrated oil company" means, with respect to any taxable year, any producer (within the meaning of section 4996(a)(1)) of crude oil other than an independent producer (within the meaning of section 4992(b)).

(6) COORDINATION WITH COST DEPLETION.—The portion of the adjusted basis of any property which is attributable to intangible drilling and development costs or mining exploration and development costs shall not be taken into account for purposes of determining depletion under section 611.

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(e) DEFINITIONS.—For purposes of this section—

(1) FINANCIAL INSTITUTION PREFERENCE ITEM.—The term financial institution preference item includes the following:

(A) EXCESS RESERVES FOR LOSSES ON BAD DEBTS OF FINANCIAL INSTITUTIONS.—In the case of a financial institution to which section 585 or 593 applies, the excess of—

(i) the amount which would, but for this section, be allowable as a deduction for the taxable year for a reasonable addition to a reserve for bad debts, over

(ii) the amount which would have been allowable had such institution maintained its bad debt reserve for all taxable years on the basis of actual experience.

(B) INTEREST ON DEBT TO CARRY TAX-EXEMPT OBLIGATIONS ACQUIRED AFTER DECEMBER 31, 1982.—

(i) IN GENERAL.—In the case of a financial institution to which section 585 or 593 applies, the amount of interest on indebtedness incurred or continued to purchase or carry obligations acquired after December 31, 1982, the interest on which is exempt from taxes for the taxable year, to the extent that a deduction would (but for this paragraph) be allowable with respect to such interest for such taxable year.

(ii) DETERMINATION OF INTEREST ALLOCABLE TO INDEBTEDNESS ON TAX-EXEMPT OBLIGATIONS.—Unless the taxpayer (under regulations prescribed by the Secretary) establishes otherwise, the amount determined under clause (i) shall be an amount which bears the same ratio to the aggregate amount allowable (determined without regard to this section) to the taxpayer as a deduction for interest for the taxable year as—

(I) the taxpayers' average adjusted basis (within the meaning of section 1016) of obligations described in clause (i), bears to

(II) such average adjusted basis for all assets of the taxpayer.

[(2) APPLICABLE CORPORATION.—For purposes of this section, the term "applicable corporation" means any corporation other than an electing small business corporation (as defined in section 1371(bb)).]

[(3)] *(2)* SECTION 1245 AND 1250 PROPERTY.—The terms "section 1245 property", "section 1245 recovery property", and "section 1250 property" have the meanings given such terms by sections 1245(a)(3), 1245(a)(5), and 1250(c), respectively.

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Subchapter E—Accounting Periods and Methods of Accounting

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PART II—METHODS OF ACCOUNTING

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Subpart A—Methods of Accounting in General

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SEC. 447. METHOD OF ACCOUNTING FOR CORPORATIONS ENGAGED IN FARMING.

(a) GENERAL RULE.— * * *

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(c) EXCEPTION FOR SMALL BUSINESS AND FAMILY CORPORATIONS.—For purposes of subsection (a), a corporation shall be treated as not being a corporation if it is—

[(1) an electing small business corporation (within the meaning of section 1371(b)),]

(1) an S corporation,

(2) a corporation of which at least 50 percent of the total combined voting power of all classes of stock entitled to vote, and at least 50 percent of the total number of shares of all other classes of stock of the corporation, are owned by members of the same family, or

(3) a corporation the gross receipt of which meet the requirements of subsection (e).

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(g) CERTAIN ANNUAL ACCRUAL ACCOUNTING METHODS.—

(1) IN GENERAL.— * * *

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(4) QUALIFIED PARTNERSHIP DEFINED.—For purposes of this subsection—

(A) QUALIFIED PARTNERSHIP.—The term "qualified partnership" means a partnership which is engaged in a qualified farming trade or business and each of the partners of which is a corporation other than—

[(i) an electing small business corporation (within the meaning of section 1371(b)), or]

(i) as S corporation, or

(ii) a personal holding company (within the meaning of section 542(a)).

(B) QUALIFIED FARMING TRADE OR BUSINESS.—The term "qualified farming trade or business" means the trade or business of farming sugar cane.

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Subpart C—Taxable Year for Which Deductions Taken

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SEC. 464. LIMITATIONS ON DEDUCTIONS IN CASE OF FARMING SYNDICATES.

(a) GENERAL RULE.—In the case of any farming syndicate (as defined in subsection (c)), a deduction (otherwise allowable under this chapter) for amounts paid for feed, seed, fertilizer, or other similar farm supplies shall only be allowed for the taxable year in which such feed, seed, fertilizer, or other supplies are actually used or consumed, or, if later, in the taxable year for which allowable as a deduction (determined without regard to this section).

(b) CERTAIN POULTRY EXPENSES.—In the case of any farming syndicate (as defined in subsection (c))—

(1) the cost of poultry (including egg-laying hens and baby chicks) purchased for use in a trade or business (or both for use in a trade or business and for sale) shall be capitalized and deducted ratably over the lesser of 12 months or their useful life in the trade or business, and

(2) the cost of poultry purchased for sale shall be deducted for the taxable year in which the poultry is sold or otherwise disposed of.

(c) FARMING SYNDICATE DEFINED.—

(1) IN GENERAL.—For purposes of this section, the term "farming syndicate" means—

(A) a partnership or any other enterprise other than a corporation which is not [an electing small business corporation (as defined in section 1371(b))] *an S corporation* engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale, or

(B) a partnership or any other enterprise other than a corporation which is not [an electing small business corporation (as defined in section 1371(b))] *an S corporation* engaged in the trade or business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.

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SEC. 465. DEDUCTIONS LIMITED TO AMOUNT AT RISK.

(a) LIMITATION TO AMOUNT AT RISK.—

(1) IN GENERAL.—In the case of—

(A) an individual, *and*

[(B) an electing small business corporation (as defined in section 1371(b)), and]

[(C)] (*B*) a corporation with respect to which the stock ownership requirement of paragraph (2) of section 542(a) is met,

engaged in an activity to which this section applies, any loss from such activity for the taxable year shall be allowed only to the extent of the aggregate amount with respect to which the taxpayer is at risk (within the meaning of subsection (b)) for such activity at the close of the taxable year.

(2) DEDUCTION IN SUCCEEDING YEAR.—Any loss from an activity to which this section applies not allowed under this section for the taxable year shall be treated as a deduction allocable to such activity in the first succeeding taxable year.

(3) SPECIAL RULES FOR APPLYING PARAGRAPH [(1)(C)] (*1*)(*B*).—For purposes of paragraph [(1)(C)] (*1*)(*B*)—

(A) section 544(a)(2) shall be applied as if such section did not contain the phrase "or by or for his partner"; and

(B) sections 544(a)(4)(A) and 544(b)(1) shall be applied by substituting "the corporation meet the stock ownership requirements of section 542(a)(2)" for "the corporation a personal holding company."

* * * * * * *

(c) ACTIVITIES TO WHICH SECTION APPLIES.—

(1) TYPES OF ACTIVITIES.—This section applies to any taxpayer engaged in the activity of—

(A) holding, producing, or distributing motion picture films or video tapes,

(B) farming (as defined in section 464(e)),

(C) leasing any section 1245 property (as defined in section 1245(a)(3)),

(D) exploring for, or exploiting, oil and gas resources, or

(E) exploring for, or exploiting, geothermal deposits (as defined in section 613(a)(3)) as a trade or business or for the production of income.

(2) SEPARATE ACTIVITIES.—For purposes of this section, a taxpayer's activity with respect to each—

(A) film or video tape,

(B) section 1245 property which is leased or held for leasing,

(C) farm,

(D) oil and gas property (as defined under section 614), or

(E) geothermal property (as defined under section 614)

shall be treated as a separate activity. A partner's interest in a partnership or a shareholder's interest in [an electing small business corporation] *an S corporation* shall be treated as a single activity to the extent that the partnership or [an electing small business corporation] *the S corporation* is engaged in activities described in any subparagraph of this paragraph.

(3) EXTENSION TO OTHER ACTIVITIES.—

(A) IN GENERAL.—In the case of taxable years beginning after December 31, 1978, this section also applies to each activity—

(i) engaged in by the taxpayer in carrying on a trade or business or for the production of income, and

(ii) which is not described in paragraph (1).

(B) AGGREGATION OF ACTIVITIES WHERE TAXPAYER ACTIVELY PARTICIPATES IN MANAGEMENT OF TRADE OR BUSINESS.—Except as provided in subparagraph (C), for purposes of this section, activities described in subparagraph (A) which constitute a trade or business shall be treated as one activity if—

(i) the taxpayer actively participates in the management of such trade or business, or

(ii) such trade or business is carried on by a partnership or [electing small business corporation (as defined in section 1371(b))] *an S corporation* and 65 percent or more of the losses for the taxable year is allocable to persons who actively participate in the management of the trade or business.

(C) AGGREGATION OR SEPARATION OF ACTIVITIES UNDER REGULATIONS.—The Secretary shall prescribe regulations under which activities described in subparagraph (A) shall be aggregated or treated as separate activities.

(D) EXCLUSIONS FOR REAL PROPERTY.—In the case of activities described in subparagraph (A), the holding of real property (other than mineral property) shall be treated as a separate activity, and subsection (a) shall not apply to losses from such activity. For purposes of the preceding sentence, personal

property and services which are incidental to making real property available as living accommodations shall be treated as part of the activity of holding such real property.

(E) APPLICATION OF SUBSECTION (b)(3).—In the case of an activity described in subparagraph (A), subsection (b)(3) shall apply only to the extent provided in regulations prescribed by the Secretary.

(4) EXCLUSION FOR CERTAIN EQUIPMENT LEASING BY CLOSELY-HELD CORPORATIONS.—

(A) IN GENERAL.—In the case of a corporation described in subsection [(a)(1)(C)] *(a)(1)(B)* actively engaged in equipment leasing—

(i) the activity of equipment leasing shall be treated as a separate activity, and

(ii) subsection (a) shall not apply to losses from such activity.

(B) 50-PERCENT GROSS RECEIPTS TEST.—For purposes of subparagraph (A), a corporation shall not be considered to be actively engaged in equipment leasing unless 50 percent or more of the gross receipts of the corporation for the taxable year is attributable, under regulations prescribed by the Secretary, to equipment leasing.

(C) COMPONENT MEMBERS OF CONTROLLED GROUP TREATED AS A SINGLE CORPORATION.—For purposes of subparagraph (A), the component members of a controlled group of corporations shall be treated as a single cororation.

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Subchapter I—Natural Resources

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PART I—DEDUCTIONS

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SEC. 613A. LIMITATIONS ON PERCENTAGE DEPLETION IN CASE OF OIL AND GAS WELLS.

(a) GENERAL RULE.— * * *

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(c) EXEMPTION FOR INDEPENDENT PRODUCERS AND ROYALTY OWNERS.—

(1) IN GENERAL.—* * *

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(13) SUBCHAPTER S CORPORATIONS.—

(A) COMPUTATION OF DEPLETION ALLOWANCE AT SHAREHOLDER LEVEL.—In the case of an S corporation, the allowance for depletion with respect to any oil or gas property shall be computed separately by each shareholder.

(B) ALLOCATION OF BASIS.—The S corporation shall allocate to each shareholder his pro rata share of the adjusted basis of the S corporation in each oil or gas property held by the S corporation. The allocation shall be made as of the later of the date of acquisition of the property by the S corporation,

or the first day of the first taxable year of the S corporation to which the Subchapter S Revision Act of 1982 applies. Each shareholder shall separately keep records of his share of the adjusted basis in each oil and gas property of the S corporation, adjust such share of the adjusted basis for any depletion taken on such property, and use such adjusted basis each year in the computation of his cost depletion or in the computation of his gain or loss on the disposition of such property by the S corporation. In the case of any distribution of oil or gas property to its shareholders by the S corporation, the corporation's adjusted basis in the property shall be an amount equal to the sum of the shareholders' adjusted bases in such property, as determined under this subparagraph.

(C) COORDINATION WITH TRANSFER RULE OF PARAGRAPH (9).—For purposes of paragraph (9)—

(i) an S corporation shall be treated as a partnership, and the shareholders of the S corporation shall be treated as partners, and

(ii) an election by a C corporation to become an S corporation shall be treated as a transfer of all its properties effective on the day on which such election first takes effect.

(D) COORDINATION WITH TRANSFER RULE OF PARAGRAPH (10).—For purposes of paragraphs (9) and (10), if an S corporation becomes a C corporation, each shareholder shall be treated as having transferred to such corporation his pro rata share of all the assets of the S corporation.

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Subchapter N—Tax Based on Income From Sources Within or Without the United States

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PART IV—DOMESTIC INTERNATIONAL SALES CORPORATIONS

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Subpart A—Treatment of Qualifying Corporations

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SEC. 992. REQUIREMENT OF A DOMESTIC INTERNATIONAL SALES CORPORATION.

(a) DEFINITION OF "DISC" AND "FORMER DISC".—* * *

* * * * * * *

(d) INELIGIBLE CORPORATIONS.—The following corporations shall not be eligible to be treated as a DISC—

(1) a corporation exempt from tax by reason of section 501,

(2) a personal holding company (as defined in section 542),

(3) a financial institution to which section 581 or 593 applies,

(4) an insurance company subject to the tax imposed by subchapter L,

(5) a regulated investment company (as defined in section 851 (a)),

(6) a China Trade Act corporation receiving the special deduction provided in section 941(a), or

[(7) an electing small business corporation (as defined in section 1371(b)).]

(7) an S corporation.

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Subchapter O—Gain or Loss on Disposition of Property

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PART II—BASIS RULES OF GENERAL APPLICATION

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SEC. 1016. ADJUSTMENTS TO BASIS.

(a) GENERAL RULE.—Proper adjustment in respect of the property shall in all cases be made—

(1) * * *

* * * * * * *

[(18) to the extent provided in section 1376 in the case of stock of, and indebtedness owing, shareholders of an electing small business corporation (as defined in section 1371(b));]

(18) to the extent provided in section 1367 in the case of stock of, and indebtedness owed to, shareholders of an S corporation;

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PART VIII—DISTRIBUTIONS PURSUANT TO BANK HOLDING COMPANY ACT

Sec. 1101. Distributions pursuant to Bank Holding Company Act.
Sec. 1102. Special rules.
Sec. 1103. Definitions.

SEC. 1101. DISTRIBUTIONS PURSUANT TO BANK HOLDING COMPANY ACT.

(a) DISTRIBUTIONS OF CERTAIN NON-BANKING PROPERTY.—

(1) DISTRIBUTIONS OF PROHIBITED PROPERTY.—If—

(A) a qualified bank holding corporation distributes prohibited property (other than stock received in an exchange to which subsection (c)(2) applies)—

(i) to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation, or

(ii) to a shareholder, in exchange for its preferred stock, or

(iii) to a security holder, in exchange for its securities, and

(B) the Board has, before the distribution, certified that the distribution of such prohibited property is necessary or appropriate to effectuate section 4 of the Bank Holding Company Act,

then no gain to the shareholder or security holder from the receipt of such property shall be recognized.

(2) DISTRIBUTIONS OF STOCK AND SECURITIES RECEIVED IN AN EXCHANGE TO WHICH SUBSECTION (c)(2) APPLIES.—If—

(A) a qualified bank holding corporation distributes—

(i) common stock received in an exchange to which subsection (c)(2) applies to a shareholder (with respect to its stock held by such shareholder), without the surrender by such shareholder of stock in such corporation, or

(ii) common stock received in an exchange to which subsection (c)(2) applies to a shareholder, in exchange for its common stock, or

(iii) common stock or common stock received in an exchange to which subsection (c)(2) applies to a shareholder, in exchange for its preferred stock, or

(iv) securities or preferred or common stock received in an exchange to which subsection (c)(2) applies to a securty holder in exchange for its securities, and

(B) any preferred stock received has substantially the same terms as the preferred stock exchanged, and any securities received have substantially the same terms as the securities exchanged,

then, except as provided in subsection (f), no gain to the shareholder or security holder from the receipt of such stock or such securities or such stock and securities shall be recognized.

(3) PRO RATA AND OTHER REQUIREMENTS.—

(A) IN GENERAL.—Paragraphs (1) and (2) of this subsection, or paragraph (1) and (2) of subsection (b), as the case may be, shall apply to any distribution to the shareholders of a qualified bank holding corporation only if each distribution—

(i) which is made by such corporation to its shareholders after July 7, 1970, and on or before the date on which the Board makes its final certification under subsection (e), and

(ii) to which such paragraph (1) or (2) applies (determined without regard to this paragraph),

meets the requirements of subparagraph (B), (C), or (D).

(B) PRO RATA REQUIREMENTS.—A distribution meets the requirements of this subparagraph if the distribution is pro rata with respect to all shareholders of the distributing qualified bank holding corporation or with respect to all shareholders of common stock of such corporation.

(C) REDEMPTIONS WHEN UNIFORM OFFER IS MADE.—A distribution meets the requirements of this subparagraph if the distribution is in exchange for stock of the distributing qualified bank holding corporation and such distribution is pursuant to a good faith offer made on a uniform basis to all shareholders of the distributing qualified bank holding corporation or to all shareholders of common stock of such corporation.

(D) NON-PRO RATA DISTRIBUTIONS FROM CERTAIN CLOSELY-HELD CORPORATION.—A distribution meets the requirements of this subparagraph if such distribution is made by a qualified bank holding corporation which does not have more than 10 shareholders (within the meaning of section [1371(a)(1)] *1361(b)(1)(A)* and does not have as a shareholder a person (other than an estate) which is not an individual, and if the Board (after consultation with the Secretary) certifies that—

(i) a distribution which meets the requirements of subparagraph (B) or (C) is not appropriate to effectuate section 4 or the policies of the Bank Holding Company Act, and

(ii) the distribution being made is necessary or appropriate to effectuate section 4 of the policies of such Act.

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Subchapter P—Capital Gains and Losses

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PART II—TREATMENT OF CAPITAL LOSSES

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SEC. 1212. CAPITAL LOSS CARRYBACKS AND CARRYOVERS.

(a) CORPORATIONS.—

(1) IN GENERAL.—* * *

* * * * * * *

[(3) ELECTING SMALL BUSINESS CORPORATIONS.—Paragraph (1)(A) shall not apply to the net capital loss of a corporation for any taxable year for which it is an electing small business corporation under subchapter S, and a net capital loss of a corporation (for a year for which it is not such an electing small business corporation) shall not be carried back under paragraph (1)(A) to a taxable year for which it is an electing small business corporation.]

[(4) *(3)* SPECIAL RULES ON CARRYBACKS.—A net capital loss of a corporation shall not be carried back under paragraph (1)(A) to a taxable year—

(A) for which it is a foreign personal holding company (as defined in section 552);

(B) for which it is a regulated investment company (as defined in section 851);

(C) for which it is a real estate investment trust (as defined in section 856); or

(D) for which an election made by it under section 1247 is applicable (relating to election by foreign investment companies to distribute income currently).

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PART IV—SPECIAL RULES FOR DETERMINING CAPITAL GAINS AND LOSSES

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SEC. 1251. GAIN FROM DISPOSITION OF PROPERTY USED IN FARMING WHERE FARM LOSSES OFFSET NONFARM INCOME.

(a) CIRCUMSTANCES UNDER WHICH SECTION APPLIES.—This section shall apply with respect to any taxable year only if—

(1) there is a farm net loss for the taxable year, or

(2) there is a balance in the excess deductions account as of the close of the taxable year after applying subsection (b)(3)(A).

(b) EXCESS DEDUCTIONS ACCOUNT.—

(1) REQUIREMENT.—Each taxpayer subject to this section shall, for purposes of this section, establish and maintain an excess deductions account.

(2) ADDITIONS TO ACCOUNT.—

(A) GENERAL RULES.—There shall be added to the excess deductions account for each taxable year an amount equal to the farm net loss.

(B) EXCEPTIONS.—In the case of an individual (other than a trust) and, except as provided in this subparagraph, in the case of [an electing small business corporation (as defined in section 1371(b))] *an S corporation*, subparagraph (A) shall apply for a taxable year—

(i) only if the taxpayer's nonfarm adjusted gross income for such year exceeds $50,000, and

(ii) only to the extent the taxpayer's farm net loss for such year exceeds $25,000.

This subparagraph shall not apply to an [electing small business corporation] *S corporation* for a taxable year if on any day of such year a shareholder of such corporation is an individual who, for his taxable year with which or within which the taxable year of the corporation ends, has a farm net loss or is a shareholder of another [electing small business corporation] *S corporation* which has a farm net loss for its taxable year ending within such taxable year of the individual. For purposes of clause (i), in the case of an [electing small business corporation] *S corporation* the nonfarm adjusted gross income of the corporation shall be increased by the amount of the nonfarm adjusted gross income of that shareholder (on any day of the corporation's taxable year) who has the highest amount of all such shareholders of nonfarm adjusted gross income for his taxable year with which or within which the taxable year of the corporation ends.

(C) MARRIED INDIVIDUALS.—In the case of a husband or wife who files a separate return, the amount specified in subparagraph (B)(i) shall be $25,000 in lieu of $50,000, and in subparagraph (B)(ii) shall be $12,500 in lieu of $25,000. This subparagraph shall not apply if the spouse of the taxpayer does not have any nonfarm adjusted gross income for the taxable year.

(D) NONFARM ADJUSTED GROSS INCOME.—For purposes of this section, the term "nonfarm adjusted gross income" means adjusted gross income (taxable income, in the case of an [electing small business corporation]) *S corporation* computed without regard to income or deductions attributable to the business of farming.

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SEC. 1254. GAIN FROM DISPOSITION OF INTEREST IN OIL, GAS, OR GEOTHERMAL PROPERTY.

(a) GENERAL RULE.—* * *

* * * * * * *

(b) SPECIAL RULES UNDER REGULATIONS.—Under regulations prescribed by the Secretary—

(1) rules similar to the rules of subsection (g) of section 617 and to the rules of subsection (b) and (c) of section 1245 shall be applied for purposes of this section; and

(2) in the case of the sale or exchange of stock in an [electing small business corporation (as defined in section 1371(b)),] *S corporation*, rules similar to the rules of section 751 shall be applied to that portion of the excess of the amount realized over the adjusted basis of the stock which is attributable to expenditures referred to in subsection (a)(1)(A) of this section.

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SEC. 1256. REGULATED FUTURES CONTRACTS MARKED TO MARKET.

(a) GENERAL RULE.— * * *

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(e) MARK TO MARKET NOT TO APPLY TO HEDGING TRANSACTIONS.—

(1) SECTION NOT TO APPLY.—Subsection (a) shall not apply in the case of a hedging transaction.

(2) DEFINITION OF HEDGING TRANSACTION.—For purposes of this subsection, the term "hedging transaction" means any transaction if—

(A) such transaction is entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily—

(i) to reduce risk of price change or currency fluctuations with respect to property which is held or to be held by the taxpayer, or

(ii) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred, by the taxpayer,

(B) the gain or loss on such transactions is treated as ordinary income or loss, and

(C) before the close of the day on which such transaction was entered into, the taxpayer clearly identifies such transaction as being a hedging transaction.

(3) SPECIAL RULE FOR SYNDICATES.—

(A) IN GENERAL.—Notwithstanding paragraph (2), the term "hedging transaction" shall not include any transaction entered into by or for a syndicate.

(B) SYNDICATE DEFINED.—For purposes of subparagraph (A), the term "syndicate" means any partnership or other entity (other than a corporation which is not an [electing small business corporation within the meaning of section 1371 (b)] *S corporation*) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)).

* * * * * * *

[Subchapter S—Election of Certain Small Business Corporations as to Taxable Status

[Sec. 1371. Definitions.
[Sec. 1372. Election by small business corporation.
[Sec. 1373. Corporation undistributed taxable income taxed to shareholders.
[Sec. 1374. Corporation net operating loss allowed to shareholders.
[Sec. 1375. Special rules applicable to distributions of electing small business corporations.
[Sec. 1376. Adjustment to basis of stock of, and indebtedness owing, shareholders.
[Sec. 1377. Special rules applicable to earnings and profits of electing small business corporations.
[Sec. 1378. Tax imposed on certain capital gains.
[Sec. 1379. Certain qualified pension, etc., plans.

[SEC. 1371. DEFINITIONS.

[(a) SMALL BUSINESS CORPORATION.—For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not a member of an affiliated group (as defined in section 1504) and which does not—

[(1) have more than 25 shareholders;

[(2) have as a shareholder a person (other than an estate and other than a trust described in subsection (e)) who is not an individual;

[(3) have a nonresident alien as a shareholder; and

[(4) have more than one class of stock.

[(b) ELECTING SMALL BUSINESS CORPORATION.—For purposes of this subchapter, the term "electing small business corporation" means, with respect to any taxable year, a small business corporation which has made an election under section 1372(a) which, under section 1372, is in effect for such taxable year.

[(c) STOCK OWNED BY HUSBAND AND WIFE.—For purposes of subsection (e)(1), a husband and wife (and their estates) shall be treated as one shareholder.

[(d) OWNERSHIP OF CERTAIN STOCK.—For purposes of subsection (a), a corporation shall not be considered a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation—

[(1) has not begun business at any time on or after the date of its incorporation and before the close of such taxable year, and

[(2) does not have taxable income for the period included within such taxable year.

[(e) CERTAIN TRUSTS PERMITTED AS SHAREHOLDERS.—

[(1) IN GENERAL.—For purposes of subsection (a), the following trusts may be shareholders:

[(A) A trust all of which is treated (under subpart E of part 1 of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.

[(B) A trust which was described in subparagraph (A) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 60-day period beginning on the day of the deemed owner's death. If a trust is described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence shall be applied by substituting "2-year period" for "60-day period".

[(C) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 60-day period beginning on the day on which such stock is transferred to it.

[(D) A trust created primarily to exercise the voting power of stock transferred to it.

[(2) TREATMENT AS SHAREHOLDERS.—For purposes of subsection (a)—

[(A) In the case of a trust described in subparagraph (A) of paragraph (1), the deemed owner shall be treated as the shareholder.

[(B) In the case of a trust described in subparagraph (B) of paragraph (1), the estate of the deemed owner shall be treated as the shareholder.

[(C) In the case of a trust described in subparagraph (C) of paragraph (1), the estate of the testator shall be treated as the shareholder.

[(D) In the case of a trust described in subparagraph (D) of paragraph (1), each beneficiary of the trust shall be treated as a shareholder.

[(f) ESTATE OF INDIVIDUAL IN TITLE 11 CASE MAY BE SHAREHOLDER.—For purposes of subsection (a)(2), the term 'estate" includes the estate of an individual in a case under 11 of the United States Code.

[(g) SPECIAL RULE FOR QUALIFIED SUBCHAPTER S TRUST.—

[(1) IN GENERAL.—In the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under paragraph (2)—

[(A) such trust shall be treated as a trust described in subsection (e)(1)(A), and

[(B) for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an electing small business corporation with respect to which the election under paragraph (2) is made.

[(2) ELECTION.—

[(A) IN GENERAL.—A beneficiary of a qualified subchapter S trust (or his legal representative) may elect to have this subsection apply.

[(B) MANNER AND TIME OF ELECTION.—An election under this paragraph shall be made—

[(i) separately with respect to each electing small business corporation the stock of which is held by the trust,

[(ii) separately with respect to each successive income beneficiary of the trust, and

[(iii) in such manner and form, and at such time, as the Secretary may prescribe.

[(C) ELECTION IRREVOCABLE.—An election under this paragraph, once made, may be revoked only with the consent of the Secretary.

[(D) GRACE PERIOD.—An election under this paragraph shall be effective up to 60 days before the date of the election.

[(3) QUALIFIED SUBCHAPTER S TRUST.—For purposes of this subsection, the term "qualified subchapter S trust" means a trust—

[(A) which owns stock in 1 or more electing small business corporations,

[(B) all of the income of which is distributed currently to one individual who is a citizen or resident of the United States, and

[(C) the terms of which require that—

[(i) at any time, there shall be only one income beneficiary of the trust,

[(ii) any corpus distributed during the term of the trust may be distributed only to the current income beneficiary thereof,

[(iii) each income interest in the trust shall terminate on the earlier of the death of the income beneficiary or the termination of the trust, and

[(iv) upon the termination of the trust during the life of an income beneficiary, the trust shall distribute all of its assets to such income beneficiary.

[(4) TRUST CEASING TO BE QUALIFIED.—If a qualified subchapter S trust ceases to meet any requirement under paragraph (3), the provisions of this subsection shall not apply to such trust as of the date it ceases to meet such requirements.

[SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION.

[(a) ELIGIBILITY.—Except as provided in subsection (f), any small business corporation may elect, in accordance with the provisions of this section, not to be subject to the taxes imposed by this chapter. Such election shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

[(b) EFFECT.—If a small business corporation makes an election under subsection (a), then—

[(1) with respect to the taxable years of the corporation for which such election is in effect, such corporation shall not be subject to the taxes imposed by this chapter (other than as provided by section 58(d)(2) and by section 1378) and, with respect to such taxable years and all succeeding taxable years, the provisions of section 1377 shall apply to such corporation, and

[(2) with respect to the taxable years of a shareholder of such corporation in which or with which the taxable years of the corporation for which such election is in effect end, the provisions of sections 1373, 1374, and 1375 shall apply to such shareholder, and with respect to such taxable years and all succeeding taxable years, the provisions of section 1376 shall apply to such shareholder.

[(c) WHEN AND HOW MADE.—

[(1) IN GENERAL.—An election under subsection (a) may be made by a small business corporation for any taxable year—

[(A) at any time during the preceding taxable year, or

[(B) at any time during the first 75 days of the taxable year.

[(2) TREATMENT OF CERTAIN LATE ELECTIONS.—If—

[(A) a small business corporation makes an election under subsection (a) for any taxable year, and

[(B) such election is made after the first 75 days of the taxable year and on or before the last day of such taxable year, then such election shall be treated as made for the following taxable year.

[(3) MANNER OF MAKING ELECTION.—An election under subsection (a) shall be made in such manner as the Secretary shall prescribe by regulations.

[(d) YEARS FOR WHICH EFFECTIVE.—An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, unless it is terminated, with respect to any such taxable year, under subsection (e).

[(e) TERMINATION.—

[(1) NEW SHAREHOLDERS.—

[(A) An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation on the day on which the election is made becomes a shareholder in such corporation and affirmatively refuses (in such manner as the Secretary may by regulations prescribe) to consent to such election on or before the 60th day after the day on which he acquires the stock.

[(B) If the person acquiring the stock is the estate of a decedent, the period under subparagraph (A) for affirmatively refusing to consent to the election shall expire on the 60th day after whichever of the following is the earlier:

[(i) The day on which the executor or administrator of the estate qualifies; or

[(ii) The last day of the taxable year of the corporation in which the decedent died.

[(C) Any termination of an election under subparagraph (A) by reason of the affirmative refusal of any person to consent to such election shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation (or, if later, the first taxable year for which such election would otherwise have been effective) and for all succeeding taxable years of the corporation.

[(2) REVOCATION.—An election under subsection (a) made by a small business corporation may be revoked by it for any taxable year of the corporation after the first taxable year for which the election is effective. An election may be revoked only if all persons who are shareholders in the corporation on the day on which the revocation is made consent to the revocation. A revocation under this paragraph shall be effective—

[(A) for the taxable year in which made, if made before the close of the first month of such taxable year,

[(B) for the taxable year following the taxable year in which made, if made after the close of such first month,

and for all succeeding taxable years of the corporation. Such revocation shall be made in such manner as the Secretary shall prescribe by regulations.

[(3) CEASES TO BE SMALL BUSINESS CORPORATION.—An election under subsection (a) made by a small business corporation shall terminate if at any time—

[(A) after the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

[(B) after the day on which the election is made, if such election is made after such first day,

the corporation ceases to be a small business corporation (as defined in section 1371(a)). Such termination shall be effective for the taxable year of the corporation in which the corporation ceases to be a small business corporation and for all succeeding taxable years of the corporation.

[(4) FOREIGN INCOME.—An election under subsection (a) made by a small business corporation shall terminate if for any taxable year of the corporation for which the election is in effect, such corporation derives more than 80 percent of its gross receipts from sources outside the United States. Such termination shall be effective for the taxable year of the corporation in which it derives more than 80 percent of its gross receipts from sources outside the United States, and for all succeeding taxable years of the corporation.

[(5) PASSIVE INVESTMENT INCOME.—

[(A) Except as provided in subparagraph (B), an election under subsection (a) made by a small business corporation shall terminate if, for any taxable year of the corporation for which the election is in effect, such corporation has gross receipts more than 20 percent of which is passive investment income. Such termination shall be effective for the taxable year of the corporation in which it has gross receipts of such amount, and for all succeeding taxable years of the corporation.

[(B) Subparagraph (A) shall not apply with respect to a taxable year in which a small business corporation has gross receipts more than 20 percent of which is passive investment income, if—

[(i) such taxable year is the first taxable year in which the corporation commenced the active conduct of any trade or business or the next succeeding taxable year; and

[(ii) the amount of passive investment income for such taxable year is less than $3,000.

[(C) For purposes of this paragraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom). Gross receipts derived from sales or exchanges of stock or securities for purposes of this paragraph shall not include amounts received by an electing small business corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the electing small business corporation owned more than 50 percent of each class of the stock of the liquidating corporation.

[(f) ELECTION AFTER TERMINATION.—If a small business corporation has made an election under subsection (a) and if such election has been terminated or revoked under subsection (e), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year prior to its fifth taxable year which begins after the first taxable year for which such termination or revocation is effective, unless the Secretary consents to such election.

[SEC. 1373. CORPORATION UNDISTRIBUTED TAXABLE INCOME TAXED TO SHAREHOLDERS.

[(a) GENERAL RULE.—The undistributed taxable income of an electing small business corporation for any taxable year shall be included in the gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

[(b) AMOUNT INCLUDED IN GROSS INCOME.—Each person who is a shareholder of an electing small business corporation on the last day of a taxable year of such corporation shall include in his gross income, for his taxable year in which or with which the taxable year of the corporation ends, the amount he would have received as a dividend, if on such last day there had been distributed pro rata to its shareholders by such corporation an amount equal to the corporation's undistributed taxable income for the corporation's taxable year. For purposes of this chapter, the amount so included shall be treated as an amount distributed as a dividend on the last day of the taxable year of the corporation.

[(c) UNDISTRIBUTED TAXABLE INCOME DEFINED.—For purposes of this section, the term "undistributed taxable income" means taxable income (computed as provided in subsection (d)) minus the sum of (1) the taxes imposed by sections 56 and 1378(a) and (2) the amount of money distributed as dividends during the taxable year, to the extent that any such amount is a distribution out of earnings and profits of the taxable year as specified in section 361(a)(2).

[(d) TAXABLE INCOME.—For purposes of this subbchapter, the taxable income of an electing small business corporation shall be determined without regard to—

[(1) the deduction allowed by section 172 (relating to net operating loss deduction), and

[(2) the deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).

[SEC. 1374. CORPORATION NET OPERATING LOSS ALLOWED TO SHAREHOLDERS.

[(a) GENERAL RULE.—A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

[(b) ALLOWANCE OF DEDUCTION.—Each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), an amount equal to his portion of the corporation's net operating loss (as determined under subsection (c)). The deduction allowed by this subsection shall, for purposes of this chapter, be considered as a deduction attributable to a trade or business carried on by the shareholder.

[(c) DETERMINATION OF SHAREHOLDER'S PORTION.—

[(1) IN GENERAL.—For purposes of this section, a shareholder's portion of the net operating loss of an electing small business corporation is his pro rata share of the corporation's net operating loss (computed as provided in section 172(c), except that the deductions provided in part VIII (except section 248) of subchapter B shall not be allowed) for his taxable year in which or with which the taxable year of the corporation ends. For purposes of this paragraph, a shareholder's pro rata share of the corporation's net operating loss is the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year. For purposes of the preceding sentence, the corporation's daily net operating loss is the corporation's net operating loss divided by the number of days in the taxable year.

[(2) LIMITATION.—A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of—

[(A) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of the shareholder's stock in the electing small business corporation, determined as of the close of the taxable year of the corporation, (or, in respect of stock sold or otherwise disposed of during such taxable year, as of the day before the day of such sale or other disposition), and

[(B) the adjusted basis (determined without regard to any adjustment under section 1376 for the taxable year) of any indebtedness of the corporation to the shareholder, determined as of the close of the taxable year of the corporation (or, if the shareholder is not a shareholder as of the close of such taxable year, as of the close of the last day in such

taxable year on which the shareholder was a shareholder in the corporation).

[SEC. 1375. SPECIAL RULES APPLICABLE TO DISTRIBUTIONS OF ELECTING SMALL BUSINESS CORPORATIONS.

[(a) CAPITAL GAINS.—

[(1) TREATMENT IN HANDS OF SHAREHOLDERS.—The amount includible in the gross income of a shareholder as dividends (including amounts treated as dividends under section 1373(b)) from an electing small business corporation during any taxable year of the corporation, to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a)(2), shall be treated as a long-term capital gain to the extent of the shareholder's pro rata share of the corporation's net capital gain for such taxable year. For purposes of this paragraph, such net capital gain shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

[(2) DETERMINATION OF SHAREHOLDER'S PRO RATA SHARE.—A shareholder's pro rata share of such gain for any taxable year shall be an amount which bears the same ratio to such gain as the amount of dividends described in paragraph (1) includible in the shareholder's gross income bears to the entire amount of dividends described in paragraph (1) includible in the gross income of all shareholders.

[(3) REDUCTION FOR TAXES IMPOSED.—For purposes of paragraphs (1) and (2), an electing small business corporation's net capital gain for a taxable year shall be reduced by an amount equal to the amount of the taxes imposed by sections 56 and 1378(a) on such corporation for such year.

[(b) DIVIDENDS NOT TREATED AS SUCH FOR CERTAIN PURPOSES.—The amount includible in the gross income of a shareholder as dividends from an electing small business corporation during any taxable year of the corporation (including any amount treated as a dividend under section 1373(b)) shall not be considered a dividend for purposes of section 37 or section 116 to the extent that such amount is a distribution of property out of earnings and profits of the taxable year as specified in section 316(a)(2). For purposes of this subsection, the earnings and profits of the taxable year shall be deemed not to exceed the corporation's taxable income (computed as provided in section 1373(d)) for the taxable year.

[(c) TREATMENT OF FAMILY GROUPS.—Any dividend received by a shareholder from an electing small business corporation (including any amount treated as a dividend under section 1373(b)) may be apportioned or allocated by the Secretary between or among shareholders of such corporation who are members of such shareholder's family (as defined in section 704(e)(3)), if he determines that such apportionment or allocation is necessary in order to reflect the value of services rendered to the corporation by such shareholders.

[(d) DISTRIBUTIONS OF UNDISTRIBUTED TAXABLE INCOME PREVIOUSLY TAXED TO SHAREHOLDERS.—

[(1) DISTRIBUTIONS NOT CONSIDERED AS DIVIDENDS.—An electing small business corporation may distribute, in accordance with reg-

ulations prescribed by the Secretary, to any shareholder all or any portion of the shareholder's net share of the corporation's undistributed taxable income for taxable years prior to the taxable year in which such distribution is made. Any such distribution shall, for purposes of this chapter, be considered a distribution which is not a dividend, but the earnings and profits of the corporation shall not be reduced by reason of any such distribution.

[(2) SHAREHOLDER'S NET SHARE OF UNDISTRIBUTED TAXABLE INCOME.—For purposes of this subsection, a shareholder's net share of the undistributed taxable income of an electing small business corporation is an amount equal to—

[(A) the sum of the amounts included in the gross income of the shareholder under section 1373(b) for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), reduced by

[(B) the sum of—

[(i) the amounts allowable under section 1374(b) as a deduction from gross income of the shareholder for all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year), and

[(ii) all amounts previously distributed during the taxable year and all prior taxable years (excluding any taxable year to which the provisions of this section do not apply and all taxable years preceding such year) to the shareholder which under subsection (f) or paragraph (1) of this subsection were considered distributions which were not dividends.

[(f) DISTRIBUTIONS WITHIN 2½-MONTH PERIOD AFTER CLOSE OF TAXABLE YEAR—

[(1) DISTRIBUTORS CONSIDERED AS DISTRIBUTIONS OF UNDISTRIBUTED TAXABLE INCOME.—Any distribution of money made by a corporation after the close of a taxable year with respect to which it was an electing small business corporation and on or before the 15th day of the third month following the close of such taxable year to a person who was a shareholder of such corporation at the close of such taxable year shall be treated as a distribution of the corporation's undistributed taxable income for such year, to the extent such distribution (when added to the sum of all prior distributions of money made to such person by such corporation following the close of such year) does not exceed such person's share of the corporation's undistributed taxable income for such year. Any distribution so treated shall, for purposes of this chapter, be considered a distribution which is not a dividend, and the earnings and profits of the corporation shall not be reduced by reason of such distribution.

[(2) SHARE OF UNDISTRIBUTED TAXABLE INCOME.—For purposes of paragraph (1), a person's share of a corporation's undistributed taxable income for a taxable year is the amount required to be included in his gross income under section 1373(b) as a share-

holder of such corporation for his taxable year in which or with which the taxable year of the corporation ends.

[SEC. 1376. ADJUSTMENT TO BASIS OF STOCK OF, AND INDEBTEDNESS OWING SHAREHOLDERS.

[(a) INCREASE IN BASIS OF STOCK FOR AMOUNTS TREATED AS DIVIDENDS.—The basis of a shareholder's stock in an electing small business corporation shall be increased by the amount required to be included in the gross income of such shareholder under section 1373(b), but only to the extent to which such amount is included in his gross income in his return, increased or decreased by any adjustment of such amount in any redetermination of the shareholder's tax liability.

[(b) REDUCTION IN BASIS OF STOCK AND INDEBTEDNESS FOR SHAREHOLDER'S PORTION OF CORPORATION NET OPERATING LOSS.—

[(1) REDUCTION IN BASIS OF STOCK.—The basis of a shareholder's stock in an electing small business corporation shall be reduced (but not below zero) by an amount equal to the amount of his portion of the corporation's net operating loss for any taxable year attributable to such stock (as determined under section 1374(c)).

[(2) REDUCTION IN BASIS INDEBTEDNESS.—The basis of any indebtedness of an electing small business corporation to a shareholder of such corporation shall be reduced (but not below zero) by an amount equal to the amount of the shareholder's portion of the corporation's net operating loss for any taxable year (as determined under section 1374(c)), but only to the extent that such amount exceeds the adjusted basis of the stock of such corporation held by the shareholder.

[SEC. 1377. SPECIAL RULES APPLICABLE TO EARNINGS AND PROFITS OF ELECTING SMALL BUSINESS CORPORATIONS.

[(a) REDUCTION FOR UNDISTRIBUTED TAXABLE INCOME.—The accumulated earnings and profits of an electing small business corporation as of the close of its taxable year shall be reduced to the extent that its undistributed taxable income for such year is required to be included in the gross income of the shareholders of such corporation under section 1373(b).

[(b) CURRENT EARNINGS AND PROFITS NOT REDUCED BY ANY AMOUNT NOT ALLOWABLE AS DEDUCTION.—The earnings and profits of an electing small business corporation for any taxable year (but not its accumulated earnings and profits) shall not be reduced by any amount which is not allowable as a deduction in computing its taxable income (as provided in section 1373(d)) for such taxable year.

[(c) EARNINGS AND PROFITS NOT AFFECTED BY NET OPERATING LOSS.—The earnings and profits and the accumulated earnings and profits of an electing small business corporation shall not be affected by any item of gross income or any deduction taken into account in determining the amount of any net operating loss (computed as provided in section 1374(c)) of such corporation.

[(d) DISTRIBUTIONS OF UNDISTRIBUTED TAXABLE INCOME PREVIOUSLY TAXED TO SHAREHOLDERS.—For purposes of determining whether a distribution by an electing small business corporation constitutes a distribution of such corporation's undistributed taxable income previously taxed to shareholders (as provided for in section 1375(d)), the earnings and profits of such corporation for the taxable

year in which the distribution is made shall be computed without regard to section 312(k). Such computation shall be made without regard to section 312(k) only for such purposes.

[SEC. 1378. TAX IMPOSED ON CERTAIN CAPITAL GAINS.

[(a) GENERAL RULE.—If for a taxable year of an electing small business corporation—

[(1) the net capital gain of such corporation exceeds $25,000, and exceeds 50 percent of its taxable income for such year, and

[(2) the taxable income of such corporation for such year exceeds $25,000, there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation.

[(b) AMOUNT OF TAX.—The tax imposed by subsection (a) shall be the lower of—

[(1) an amount equal to the tax, determined as provided in section 1201(a), on the amount by which the net capital gain of the corporation for the taxable year exceeds $25,000, or

[(2) an amount equal to the tax which would be imposed by section 11 on the taxable income (computed as provided in section 1373(d)) of the corporation for the taxable year if the corporation was not an electing small business corporation.

[No credit shall be allowable under part IV of subchapter A of this chapter (other than under section 39) against the tax imposed by subsection (a).

[(c) EXCEPTIONS.—

[(1) IN GENERAL.—Subsection (a) shall not apply to an electing small business corporation for any taxable year if the election under section 1372(a) which is in effect with respect to such corporation for such taxable year has been in effect for the 3 immediately preceding taxable years.

[(2) NEW CORPORATIONS.—Subsection (a) shall not apply to an electing small business corporation if—

[(A) it has been in existence for less than 4 taxable years, and

[B) an election under section 1372(a) has been in effect with respect to such corporation for each of its taxable years.

[(3) PROPERTY WITH SUBSTITUTE BASIS.—If—

[(A) but for paragraph (1) or (2), subsection (a) would apply for the taxable year,

[B) any long-term capital gain is attributable to property acquired by the electing small business corporation during the period beginning 3 years before the first day of the taxable year and ending on the last day of the taxable year, and

[(C) the basis of such property is determined in whole or in part by reference to the basis of any property in the hands of another corporation which was not an electing small business corporation throughout all of the period described in subparagraph (B) before the transfer by such other corporation and during which such other corporation was in existence,

[then subsection (a) shall apply for the taxable year, but the amount of the tax determined under subsection (b) shall not exceed a tax, determined as provided in section 1201(a), on the net capital gain at-

tributable to property acquired as provided in subparagraph (B) and having a basis described in subparagraph (C).

[SEC. 1379. CERTAIN QUALIFIED PENSIONS, ETC., PLANS.

[(a) ADDITIONAL REQUIREMENT FOR QUALIFICATION OF STOCK BONUS OR PROFIT-SHARING PLANS.—A trust forming part of a stock or profit-sharing plan which provides contributions or benefits for employees some or all of whom are shareholder-employees shall not constitute a qualified trust under section 401 (relating to qualified pension, profit-sharing, and stock bonus plans) unless the plan of which such trust is a part provides that forfeitures attributable to contributions deductible under section 404(a)(3) for any taxable year (beginning after December 31, 1970) of the employer with respect to which it is an electing small business corporation may not inure to the benefit of any individual who is a shareholder-employee for such taxable year. A plan shall be considered as satisfying the requirement of this subsection for the period beginning with the first day of a taxable year and ending with the 15th day of the third month following the close of such taxable year, if all the provisions of the plan which are necessary to satisfy this requirement are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period.

[(b) TAXABILITY OF SHAREHOLDERS-EMPLOYEE BENEFICIARIES.—

[(1) INCLUSION OF EXCESS CONTRIBUTIONS IN GROSS INCOME.—Notwithstanding the provisions of section 402 (relating to taxability of beneficiary of employees' trust), section 403 (relating to taxation of employee annuities), or section 405(d) (relating to taxability of beneficiaries under qualified bond purchase plans), an individual who is a shareholder-employee of an electing small business corporation shall include in gross income, for his taxable year in which or with which the taxable year of the corporation ends, the excess of the amount of contributions paid on his behalf which is deductible under section 404(a)(1), (2), or (3) by the corporation for its taxable year over the lesser of—

[(A) 15 percent of the compensation received or accrued by him from such corporation during its taxable year, or

[(B) $15,000.

[(2) TREATMENT OF AMOUNTS INCLUDED IN GROSS INCOME.—Any amount included in the gross income of a shareholder-employee under paragraph (1) shall be treated as consideration for the contract contributed by the shareholder-employee for purposes of section 72 (relating to annuities).

[(3) DEDUCTION FOR AMOUNTS NOT RECEIVED AS BENEFITS.—If—

[(A) amounts are included in the gross income of an individual under paragraph (1), and

[(B) the rights of such individual (or his beneficiaries) under the plan terminate before payments under the plan which are excluded from gross income equal the amounts included in gross income under paragraph (1).

[then there shall be allowed as a deduction, for the taxable year in which such rights terminate, an amount equal to the excess of the amounts included in gross income under paragraph (1) over such payments.

[(c) CARRYOVER OF AMOUNTS DEDUCTIBLE.—No amount deductible shall be carried forward under the second sentence of section 404(a)(3)(A) (relating to limits on deductible contributions under stock bonus and profit-sharing trusts) to a taxable year of a corporation with respect to which it is not an electing small business corporation from a taxable year (beginning after December 31, 1970) with respect to which it is an electing small business corporation.

[(d) SHAREHOLDER-EMPLOYEE.—For purposes of this section, the term "shareholder-employee" means an employee or officer of an electing small business corporation who owns (or is considered as owning within the meaning of section 318(a)(1)), on any day during the taxable year of such corporation, more than 5 percent of the outstanding stock of the corporation.]

"Subchapter S—Tax Treatment of S Corporations and Their Shareholders

Part I. In general.
Part II. Tax treatment of shareholders.
Part III. Special rules.
Part IV. Definitions; miscellaneous.

PART I—IN GENERAL

Sec. 1361. S. corporation defined.
Sec. 1362. Election; revocation; termination.
Sec. 1363. Effect of election on corporation.

SEC. 1361. S CORPORATION DEFINED.

(a) S CORPORATION DEFINED.—

(1) IN GENERAL.—For purposes of this title, the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under section 1362(a) is in effect for such year.

(2) C CORPORATION.—For purposes of this title, the term "C corporation" means, with respect to any taxable year, a corporation which is not an S corporation for such year.

(b) SMALL BUSINESS CORPORATION.—

(1) IN GENERAL.—For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not—

(A) have more than 35 shareholders,

(B) have as a shareholder a person (other than an estate and other than a trust described in subsection (c)(2)) who is not an individual,

(C) have a nonresident alien as a shareholder, and

(D) have more than 1 class of stock.

(2) INELIGIBLE CORPORATION DEFINED.—For purposes of paragraph (1), the term "ineligible corporation" means any corporation which is—

(A) a member of an affiliated group (determined under section 1504 without regard to the exceptions contained in subsection (b) thereof),

(B) a financial institution to which section 585 or 593 applies,

(C) an insurance company subject to tax under subchapter L,

(D) a corporation to which an election under section 936 applies, or

(E) a DISC or former DISC.

(c) SPECIAL RULES FOR APPLYING SUBSECTION (b).—

(1) HUSBAND AND WIFE TREATED AS 1 SHAREHOLDER.—For purposes of subsection (b)(1)(A), a husband and wife (and their estates) shall be treated as 1 shareholder.

(2) CERTAIN TRUSTS PERMITTED AS SHAREHOLDERS.—

(A) IN GENERAL.—For purposes of subsection (b)(1)(B), the following trusts may be shareholders:

(i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.

(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 60-day period beginning on the day of the deemed owner's death. If a trust is described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence shall be applied by substituting "2-year period" for "60-day period".

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 60-day period beginning on the day on which such stock is transferred to it.

(iv) A trust created primarily to exercise the voting power of stock transferred to it.

This subparagraph shall not apply to any foreign trust.

(B) TREATMENT AS SHAREHOLDERS.—For purposes of subsection (b)(1)—

(i) In the case of a trust described in clause (i) of subparagraph (A), the deemed owner shall be treated as the shareholder.

(ii) In the case of a trust described in clause (ii) of subparagraph (A), the estate of the deemed owner shall be treated as the shareholder.

(iii) In the case of a trust described in clause (iii) of subparagraph (A), the estate of the testator shall be treated as the shareholder.

(iv) In the case of a trust described in clause (iv) of subparagraph (A), each beneficiary of the trust shall be treated as a shareholder.

(3) ESTATE OF INDIVIDUAL IN BANKRUPTCY MAY BE SHAREHOLDER.—For purposes of subsection (b)(1)(B), the term "estate" includes the estate of an individual in a case under title 11 of the United States Code.

(4) DIFFERENCES IN COMMON STOCK VOTING RIGHTS DISREGARDED.—For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there

are differences in voting rights among the shares of common stock.

(5) STRAIGHT DEBT SAFE HARBOR.—

(A) IN GENERAL.—For purposes of subsection (b)(1)(D), straight debt shall not be treated as a second class of stock.

(B) STRAIGHT DEBT DEFINED.—For purposes of this paragraph, the term "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain in money if—

(i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors,

(ii) there is no convertibility (directly or indirectly) into stock, and

(iii) the creditor is an individual (other than a nonresident alien), an estate, or a trust described in paragraph (2).

(C) REGULATIONS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to provide for the proper treatment of straight debt under this subchapter and for the coordination of such treatment with other provisions of this title.

(6) OWNERSHIP OF STOCK IN CERTAIN INACTIVE CORPORATIONS.—For purposes of subsection (b)(2)(A), a corporation shall not be treated as a member of an affiliated group at any time during any taxable year by reason of the ownership of stock in another corporation if such other corporation—

(A) has not begun business at any time on or after the date of its incorporation and before the close of such taxable year, and

(B) does not have taxable income for the period included within such taxable year.

(d) SPECIAL RULE FOR QUALIFIED SUBCHAPTER S TRUST.—

(1) IN GENERAL.—In the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under paragraph (2)—

(A) such trust shall be treated as a trust described in subsection (c)(2)(A)(i), and

(B) for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made.

(2) ELECTION.—

(A) IN GENERAL.—A beneficiary of a qualified subchapter S trust (or his legal representative) may elect to have this subsection apply.

(B) MANNER AND TIME OF ELECTION.—An election under this paragraph shall be made—

(i) separately with respect to each S corporation the stock of which is held by the trust,

(ii) separately with respect to each successive income beneficiary of the trust, and

(iii) in such manner and form, and at such time, as the Secretary may prescribe.

(C) ELECTION IRREVOCABLE.—An election under this paragraph, once made, may be revoked only with the consent of the Secretary.

(D) GRACE PERIOD.—An election under this paragraph shall be effective up to 60 days before the date of the election.

(3) QUALIFIED SUBCHAPTER S TRUST.—For purposes of this subsection, the term "qualified subchapter S trust" means a trust—

(A) which owns stock in 1 or more S corporations,

(B) all of the income (within the meaning of section 643 (b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States, and

(C) the terms of which require that—

(i) at any time, there shall be only 1 income beneficiary of the trust,

(ii) any corpus distributed during the term of the trust may be distributed only to the current income beneficiary thereof,

(iii) each income interest in the trust shall terminate on the earlier of the death of the income beneficiary or the termination of the trust, and

(iv) upon the termination of the trust during the life of an income beneficiary, the trust shall distribute all of its assets to such income beneficiary.

(4) TRUST CEASING TO BE QUALIFIED.—If a qualified subchapter S trust ceases to meet any requirement under paragraph (3), the provisions of this subsection shall not apply to such trust as of the date it ceases to meet such requirements.

SEC. 1362. ELECTION; REVOCATION; TERMINATION.

(a) ELECTION.—

(1) IN GENERAL.—Except as provided in subsection (g), a small business corporation may elect, in accordance with the provisions of this section, to be an S corporation.

(2) ALL SHAREHOLDERS MUST CONSENT TO ELECTION.—An election under this subsection shall be valid only if all persons who are shareholders in such corporation on the day on which such election is made consent to such election.

(b) WHEN MADE.—

(1) IN GENERAL.—An election under subsection (a) may be made by a small business corporation for any taxable year—

(A) at any time during the preceding taxable year, or

(B) at any time during the taxable year and on or before the 15th day of the 3d month of the taxable year.

(2) CERTAIN ELECTIONS MADE DURING 1ST 2½ MONTHS TREATED AS MADE FOR NEXT TAXABLE YEAR.—If—

(A) an election under subsection (a) is made for any taxable year during such year and on or before the 15th day of the 3d month of such year, but

(B) either—

(i) on 1 or more days in such taxable year before the day on which the election was made the corporation did not meet the requirements of subsection (b) of section 1361, or

(ii) 1 or more of the persons who held stock in the corporation during such taxable year and before the election was made did not consent to the election,

then such election shall be treated as made for the following taxable year.

(3) ELECTION MADE AFTER 1ST 2½ MONTHS TREATED AS MADE FOR FOLLOWING TAXABLE YEAR.—If—

(A) a small business corporation makes an election under subsection (a) for any taxable year, and

(B) such election is made after the 15th day of the 3d month of the taxable year and on or before the last day of such taxable year,

then such election shall be treated as made for the following taxable year.

(c) YEARS FOR WHICH EFFECTIVE.—An election under subsection (a) shall be effective for the taxable year of the corporation for which it is made and for all succeeding taxable years of the corporation, until such election is terminated under subsection (d).

(d) TERMINATION.—

(1) BY REVOCATION.—

(A) IN GENERAL.—An election under subsection (a) may be terminated by revocation.

(B) MORE THAN ONE-HALF OF SHARES MUST CONSENT TO REVOCATION.—An election may be revoked only if shareholders holding more than one-half of the shares of stock of the corporation on the day on which the revocation is made consent to the revocation.

(C) WHEN EFFECTIVE.—Except as provided in subparagraph (D)—

(i) a revocation made during the taxable year and on or before the 15th day of the 3d month thereof shall be effective on the 1st day of such taxable year, and

(ii) a revocation made during the taxable year but after such 15th day shall be effective on the 1st day of the following taxable year.

(D) REVOCATION MAY SPECIFY PROSPECTIVE DATE.—If the revocation specifies a date for revocation which is on or after the day on which the revocation is made, the revocation shall be effective on and after the date so specified.

(2) BY CORPORATION CEASING TO BE SMALL BUSINESS CORPORATION.—

(A) IN GENERAL.—An election under subsection (a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

(B) WHEN EFFECTIVE.—Any termination under this paragraph shall be effective on and after the date of cessation.

(3) WHERE PASSIVE INVESTMENT INCOME EXCEEDS 20 PERCENT OF GROSS RECEIPTS AND CORPORATION HAS ACCUMULATED EARNINGS AND PROFITS.—

(A) TERMINATION.—

(i) IN GENERAL.—An election under subsection (a) shall be terminated whenever the corporation—

(I) has gross receipts for any taxable year more than 20 percent of which is passive investment income, and

(II) has subchapter C earnings and profits at the close of such taxable year.

(ii) WHEN EFFECTIVE.—Any termination under this paragraph shall be effective on and after the first day of the taxable year referred to in clause (i).

(B) SUBCHAPTER C EARNINGS AND PROFITS.—For purposes of subparagraph (A), the term 'subchapter C earnings and profits' means earnings and profits of any corporation for any taxable year with respect to which an election under section 1362(a) (or under section 1372 of prior law) was not in effect.

(C) GROSS RECEIPTS FROM SALES OF CAPITAL ASSETS (OTHER THAN STOCK AND SECURITIES).—For purposes of this paragraph, in the case of dispositions of capital assets (other than stock and securities), gross receipts from such dispositions shall be taken into account only to the extent of the capital gain net income therefrom.

(D) PASSIVE INVESTMENT INCOME DEFINED.—For purposes of this paragraph—

(i) IN GENERAL.—Except as otherwise provided in this subparagraph, the term "passive investment income" means gross receipts derived from royalties, rents, dividends, interest, annuities, and sales or exchanges of stock or securities (gross receipts from such sales or exchanges being taken into account for purposes of this paragraph only to the extent of gains therefrom).

(ii) EXCEPTION FOR INTEREST ON NOTES FROM SALES OF INVENTORY.—The term "passive investment income" shall not include interest on any obligation acquired in the ordinary course of the corporation's trade or business from its sale of property described in section 1221(1).

(iii) TREATMENT OF CERTAIN LENDING OR FINANCE COMPANIES.—If the S corporation meets the requirements of section 542(c)(6) for the taxable year, the term "passive investment income" shall not include gross receipts for the taxable year which are derived directly from the active and regular conduct of a lending or finance business (as defined in section 542(d)(1)).

(iv) TREATMENT OF CERTAIN LIQUIDATIONS.—Gross receipts derived from sales or exchanges of stock or securities shall not include amounts received by an S corporation which are treated under section 331 (relating to corporate liquidations) as payments in exchange for stock where the S corporation owned more than 50 percent of each class of stock of the liquidating corporation.

(e) TREATMENT OF S TERMINATION YEAR.—

(1) IN GENERAL.—In the case of an S termination year, for purposes of this title—

(A) S SHORT YEAR.—The portion of such year ending before the 1st day for which the termination is effective shall be treated as a short taxable year for which the corporation is an S corporation.

(B) C SHORT YEAR.—The portion of such year beginning on such 1st day shall be treated as a short taxable year for which the corporation is a C corporation.

(2) PRO RATA ALLOCATION.—Except as provided in paragraph (3), the determination of which items are to be taken into account for each of the short taxable years referred to in paragraph (1) shall be made—

(A) first by determining for the S termination year—

(i) the amount of each of the items of income, loss, deduction, or credit described in section 1366(a)(1)(A), and

(ii) the amount of the nonseparately computed income or loss, and

(B) then by assigning an equal portion of each amount determined under subparagraph (A) to each day of the S termination year.

(3) ELECTION TO HAVE ITEMS ASSIGNED TO EACH SHORT TAXABLE YEAR UNDER NORMAL TAX ACCOUNTING RULES.—

(A) IN GENERAL.—A corporation may elect to have paragraph (2) not apply.

(B) ALL SHAREHOLDERS MUST CONSENT TO ELECTION.—An election under this paragraph shall be valid only if all persons who are shareholders in the corporation at any time during the S termination year consent to such election.

(4) S TERMINATION YEAR.—For purposes of this subsection, the term "S termination year" means any taxable year of a corporation (determined without regard to this subsection) in which a termination of an election made under subsection (a) takes effect (other than on the 1st day thereof).

(5) TAX FOR C SHORT YEAR DETERMINED ON ANNUALIZED BASIS.—

(A) IN GENERAL.—The taxable income for the short year described in subparagraph (B) of paragraph (1) shall be placed in an annual basis by multiplying the taxable income for such short year by the number of days in the S termination year and by dividing the result by the number of days in the short year. The tax shall be the same part of the tax computed on the annual basis as the number of days in such short years is of the number of days in the S termination year.

(B) SECTION 443(d)(2) TO APPLY.—Subsection (d)(2) of section 443 shall apply to the short taxable year described in subparagraph (B) of paragraph (1).

(6) OTHER SPECIAL RULES.—For purposes of this title—

(A) SHORT YEARS TREATED AS 1 YEAR FOR CARRYOVER PURPOSES.—The short taxable year described in subparagraph (A) of paragraph (1) shall not be taken into account for purposes of determining the number of taxable years to which any item may be carried back or carried forward by the corporation.

(B) DUE DATE FOR S YEAR.—The due date for filing the return for the short taxable year described in subparagraph (A) of paragraph (1) shall be the same as the due date for filing the return for the short taxable year described in subparagraph (B) of paragraph (1) (including extensions thereof).

(f) INADVERTENT TERMINATIONS.—If—

(1) an election under subsection (a) by any corporation was terminated under paragraph (2) or (3) of subsection (d),

(2) the Secretary determines that the termination was inadvertent,

(3) no later than a reasonable period of time after discovery of the event resulting in such termination, steps were taken so that the corporation is once more a small business corporation, and

(4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period,

then, notwithstanding the terminating event, such corporation shall be treated as continuing to be an S corporation during the period specified by the Secretary.

(g) ELECTION AFTER TERMINATION.—If a small business corporation has made an election under subsection (a) and if such election has been terminated under subsection (d), such corporation (and any successor corporation) shall not be eligible to make an election under subsection (a) for any taxable year before its 5th taxable year which begins after the 1st taxable year for which such termination is effective, unless the Secretary consents to such election.

SEC. 1363. EFFECT OF ELECTION ON CORPORATION.

(a) GENERAL RULE.—Except as otherwise provided in this subchapter and in section 58(d), an S corporation shall not be subject to the taxes imposed by this chapter.

(b) COMPUTATION OF CORPORATION'S TAXABLE INCOME.—The taxable income of an S corporation shall be computed in the same manner as in the case of an individual, except that—

(1) the items described in section 1366 (a) (1) (A) shall be separately stated,

(2) the deductions referred to in section 703(a) (2) shall not be allowed to the corporation, and

(3) section 248 shall apply.

(c) ELECTIONS OF THE S CORPORATION.—

(1) IN GENERAL.—Except as provided in paragraph (2), any election affecting the computation of items derived from an S corporation shall be made by the corporation.

(2) EXCEPTIONS.—In the case of an S corporation, elections under the following provisions shall be made by each shareholder separately—

(A) subsection (b) (5) or (d) (4) of section 108 (relating to income from discharge of indebtedness),

(B) section 163(d) (relating to limitation on interest on investment indebtedness),

(C) section 617 (relating to deduction and recapture of certain mining exploration expenditures), and

(D) section 901 (relating to taxes of foreign countries and possessions of the United States).

(d) DISTRIBUTIONS OF APPRECIATED PROPERTY.—IF—

(1) an S corporation makes a distribution of property (other than an obligation of such corporation) with respect to its stock, and

(2) the fair market value of such property exceeds its adjusted basis in the hands of the S corporation,

then, notwithstanding any other provision of this subtitle, gain shall be recognized to the S corporation on the distribution in the same manner as if it had sold property to the distributee at its fair market value.

PART II—TAX TREATMENT OF SHAREHOLDERS

Sec. 1366. Pass-thru of items to shareholders.
Sec. 1367. Adjustments to basis of stock of shareholders, etc.
Sec. 1368. Distributions.

SEC. 1366. PASS-THRU OF ITEMS TO SHAREHOLDERS.

(a) DETERMINATION OF SHAREHOLDER'S TAX LIABILITY.—

(1) IN GENERAL.—In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends (or for the final taxable year of a shareholder who dies before the end of the corporation's taxable year), there shall be taken into account the shareholder's pro rata share of the corporation's—

(A) items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and

(B) nonseparately computed income or loss.

For purposes of the preceding sentence, the items referred to in subparagraph (A) shall include amounts described in paragraph (4) or (6) of section 702(a).

(2) NONSEPARATELY COMPUTED INCOME OR LOSS DEFINED.—For purposes of this subchapter, the term "nonseparately computed income or loss" means gross income minus the deductions allowed to the corporation under this chapter, determined by excluding all items described in paragraph (1)(A).

(b) CHARACTER PASSED THRU.—The character of any item included in a shareholder's pro rata share under paragraph (1) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.

(c) GROSS INCOME OF A SHAREHOLDER.—In any case where it is necessary to determine the gross income of a shareholder for purposes of this title, such gross income shall include the shareholder's pro rata share of the gross income of the corporation.

(d) SPECIAL RULES FOR LOSSES AND DEDUCTIONS.—

(1) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK AND DEBT.—The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of—

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraph (1) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

(2) INDEFINITE CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS.—Any loss or deduction which is disallowed for any taxable year by reason of paragraph (1) shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder.

(3) CARRYOVER OF DISALLOWED LOSSES AND DEDUCTIONS TO POST-TERMINATION TRANSITION PERIOD.—

(A) IN GENERAL.—If for the last taxable year of a corporation for which it was an S corporation a loss or deduction was disallowed by reason of paragraph (1), such loss or deduction shall be treated as incurred by the shareholder on the last day of any post-termination transition period.

(B) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK.—The aggregate amount of losses and deductions taken into account by a shareholder under subparagraph (A) shall not exceed the adjusted basis of the shareholder's stock in the corporation (determined at the close of the last day of the post-termination transition period and without regard to this paragraph).

(C) ADJUSTMENT IN BASIS OF STOCK.—The shareholder's basis in the stock of the corporation shall be reduced by the amount allowed as a deduction by reason of this paragraph.

(e) TREATMENT OF FAMILY GROUP.—If an individual who is a member of the family (within the meaning of section 704(e)(3)) of one or more shareholders of an S corporation renders services for the corporation or furnishes capital to the corporation without receiving reasonable compensation therefor, the Secretary shall make such adjustments in the items taken into account by such individual and such shareholders as may be necessary in order to reflect the value of such services or capital.

(f) SPECIAL RULES.—

(1) SUBSECTION (a) NOT TO APPLY TO CREDIT ALLOWABLE UNDER SECTION 39.—Subsection (a) shall not apply with respect to any credit allowable under section 39 (relating to certain uses of gasoline, special fuels, and lubricating oil).

(2) REDUCTION IN PASS-THRU FOR TAX IMPOSED ON CAPITAL GAIN.—If any tax is imposed under section 56 or 1374 for any taxable year on an S corporation, for purposes of subsection (a)—

(A) the amount of the corporation's long-term capital gains for the taxable year shall be reduced by the amount of of such tax, and

(B) if the amount of such tax exceeds the amount of such long-term capital gains, the corporation's gains from sales or exchanges of property described in section 1231 shall be reduced by the amount of such excess.

For purposes of the preceding sentence, the term "long-term capital gain" shall not include any gain from the sale or exchange of property described in section 1231.

(g) CROSS REFERENCE.—For rules relating to procedures for determining the tax treatment of subchapter S items, see subchapter D of chapter 63.

SEC. 1367. ADJUSTMENTS TO BASIS OF STOCK OF SHAREHOLDERS, ETC.

(a) GENERAL RULE.—

(1) INCREASES IN BASIS.—The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) DECREASES IN BASIS.—The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

(E) the amount of the shareholder's deduction for depletion under section 611 with respect to oil and gas wells.

(b) SPECIAL RULES.—

(1) INCOME ITEMS.—An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) ADJUSTMENTS IN BASIS OF INDEBTEDNESS.—

(A) REDUCTION OF BASIS.—If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to re-

duce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) RESTORATION OF BASIS.—If for any taxable year there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) COORDINATION WITH SECTION 165(g).—This section and section 1366 shall be applied before the application of section 165(g) to any taxable year of the shareholder or the corporation in which the stock becomes worthless.

SEC. 1368. DISTRIBUTIONS.

(a) GENERAL RULE.—A distribution of property made by an S corporation with respect to its stock to which (but for this subsection) section 301(c) would apply shall be treated in the manner provided in subsection (b) or (c), whichever applies.

(b) S CORPORATION HAVING NO EARNINGS AND PROFITS.—In the case of a distribution described in subsection (a) by an S corporation which has no accumulated earnings and profits—

(1) AMOUNT APPLIED AGAINST BASIS.—The distribution shall not be included in gross income to the extent that it does not exceed the adjusted basis of the stock.

(2) AMOUNT IN EXCESS OF BASIS.—If the amount of the distribution exceeds the adjusted basis of the stock, such excess shall be treated as gain from the sale or exchange of property.

(c) S CORPORATION HAVING EARNINGS AND PROFITS.—In the case of a distribution described in subsection (a) by an S corporation which has accumulated earnings and profits—

(1) ACCUMULATED ADJUSTMENTS ACCOUNT.—That portion of the distribution which does not exceed the accumulated adjustments shall be treated in the manner provided by subsection (b).

(2) DIVIDEND.—That portion of the distribution which remains after the application of paragraph (1) shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S corporation.

(3) TREATMENT OF REMAINDER.—Any portion of the distribution remaining after the application of paragraph (2) of this subsection shall be treated in the manner provided by subsection (b).

(d) CERTAIN ADJUSTMENTS TAKEN INTO ACCOUNT.—Subsections (b) and (c) shall be applied by taking into account (to the extent proper)—

(1) the adjustments to the basis of the shareholder's stock described in section 1367, and

(2) the adjustments to the accumulated adjustments account which are required by subsection (e)(1).

(e) DEFINITIONS AND SPECIAL RULES.—For purposes of this section—

(1) ACCUMULATED ADJUSTMENTS ACCOUNT.—

(A) IN GENERAL.—Except as provided in subparagraph (B), the term "accumulated adjustments account" means an account of the S corporation which is adjusted for the S

period in a manner similar to the adjustments under section 1367 (except that no adjustment shall be made for income which is exempt from tax under this title and no adjustment shall be made for any expense not deductible in computing the corporation's taxable income and not properly chargeable to capital account).

(B) AMOUNT OF ADJUSTMENT IN THE CASE OF REDEMPTIONS.—In the case of any redemption which is treated as an exchange under section 302(a) or 303(a), the adjustment in the accumulated adjustments account shall be an amount which bears the same ratio to the balance in such account as the number of shares redeemed in such redemption bears to the number of shares of stock in the corporation immediately before such redemption.

(2) S PERIOD.—The term "S period" means the most recent continuous period during which the corporation has been an S corporation. Such period shall not include any taxable year beginning before January 1, 1983.

PART III—SPECIAL RULES

Sec. 1371. Coordination with subchapter C.
Sec. 1372. Partnership rules to apply for fringe benefit purposes.
Sec. 1373. Foreign income.
Sec. 1374. Tax imposed on certain capital gains.

SEC. 1371. COORDINATION WITH SUBCHAPTER C.

(a) APPLICATION OF SUBCHAPTER C RULES.—

(1) IN GENERAL.—Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders.

(2) S CORPORATION AS SHAREHOLDER TREATED LIKE INDIVIDUAL.—For purposes of subchapter C, an S corporation in its capacity as a shareholder of another corporation shall be treated as an individual.

(b) NO CARRYOVER BETWEEN C YEAR AND S YEAR.—

(1) FROM C YEAR TO S YEAR.—No carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation.

(2) NO CARRYOVER FROM S YEAR.—No carryforward, and no carryback, shall arise at the corporate level for a taxable year for which a corporation is an S corporation.

(3) TREATMENT OF S YEAR AS ELAPSED YEAR.—Nothing in paragraphs (1) and (2) shall prevent treating a taxable year for which a corporation is an S corporation as a taxable year for purposes of determining the number of taxable years to which an item may be carried back or carried forward.

(c) EARNINGS AND PROFITS.—

(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), no adjustment shall be made to the earnings and profits of an S corporation.

(2) *ADJUSTMENTS FOR REDEMPTIONS, LIQUIDATIONS, REORGANIZATIONS, DIVISIVES, ETC.—In the case of any transaction involving the application of subchapter C to any S corporation, proper adjustment to any accumulated earnings and profits of the corporation shall be made.*

(3) *ADJUSTMENTS IN CASE OF DISTRIBUTIONS TREATED AS DIVIDENDS UNDER SECTION 1368(C)(2).—Paragraph (1) shall not apply with respect to that portion of a distribution which is treated as a dividend under section 1368(c)(2).*

(d) *COORDINATION WITH INVESTMENT CREDIT RECAPTURE.—*

(1) *NO RECAPTURE BY REASON OF ELECTION.—Any election under section 1362 shall be treated as a mere change in the form of conducting a trade or business for purposes of the second sentence of section 47(b).*

(2) *CORPORATION CONTINUES TO BE LIABLE.—Notwithstanding an election under section 1362, an S corporation shall continue to be liable for any increase in tax under section 47 attributable to credits allowed for taxable years for which such corporation was not an S corporation.*

(e) *CASH DISTRIBUTIONS DURING POST-TERMINATION TRANSITION PERIOD.—Any distribution of money by a corporation with respect to its stock during a post-termination transition period shall be applied against and reduce the adjusted basis of the stock, to the extent that the amount of the distribution does not exceed the accumulated adjustments account.*

SEC. 1372. PARTNERSHIP RULES TO APPLY FOR FRINGE BENEFIT PURPOSES.

(a) *GENERAL RULE.—For purposes of applying the provisions of this subtitle which relate to employee fringe benefits—*

(1) *the S corporation shall be treated as a partnership, and*

(2) *any 2-percent shareholder of the S corporation shall be treated as a partner of such partnership.*

(b) *2-PERCENT SHAREHOLDER DEFINED.—For purposes of this section, the term "2-percent shareholder" means any person who owns (or is considered as owning within the meaning of section 318) on any day during the taxable year of the S corporation more than 2-percent of the outstanding stock of such corporation or stock possessing more than 2-percent of the total combined voting power of all stock of such corporation.*

SEC. 1373. FOREIGN INCOME.

(a) *S CORPORATION TREATED AS PARTNERSHIP ETC.—For purposes of subparts A and F of part III, and part V, of subchapter N (relating to income from sources without the United States)—*

(1) *an S corporation shall be treated as a partnership, and*

(2) *the shareholders of such corporation shall be treated as partners of such partnership.*

(b) *RECAPTURE OF OVERALL FOREIGN LOSS.—For purposes of section 904(f) (relating to recapture of overall foreign loss), the making or termination of an election to be treated as an S corporation shall be treated as a disposition of the business.*

SEC. 1374. TAX IMPOSED ON CERTAIN CAPITAL GAINS.

(a) GENERAL RULE.—If for a taxable year of an S corporation—

(1) the net capital gain of such corporation exceeds $25,000, and exceeds 50 percent of its taxable income for such year, and

(2) the taxable income of such corporation for such year exceeds $25,000,

there is hereby imposed a tax (computed under subsection (b)) on the income of such corporation.

(b) AMOUNT OF TAX.—The tax imposed by subsection (a) shall be the lower of—

(1) an amount equal to the tax, determined as provided in section 1201(a), on the amount by which the net capital gain of the corporation for the taxable year exceeds $25,000, or

(2) an amount equal to the tax which would be imposed by section 11 on the taxable income of the corporation for the taxable year if the corporation were not an S corporation.

No credit shall be allowable under part IV of subchapter A of this chapter (other than under section 39) against the tax imposed by subsection (a).

(c) EXCEPTIONS.—

(1) IN GENERAL.—Subsection (a) shall not apply to an S corporation for any taxable year if the election under section 1362(a) which is in effect with respect to such corporation for such taxable year has been in effect for the 3 immediately preceding taxable years.

(2) NEW CORPORATIONS.—Subsection (a) shall not apply to an S corporation if—

(A) it (and any predecessor corporation) has been in existence for less than 4 taxable years, and

(B) an election under section 1362(a) has been in effect with respect to such corporation for each of its taxable years.

(3) PROPERTY WITH SUBSTITUTED BASIS.—If—

(A) but for paragraph (1) or (2), subsection (a) would apply for the taxable year,

(B) any long-term capital gain is attributable to property acquired by the S corporation during the period beginning 3 years before the first day of the taxable year and ending on the last day of the taxable year, and

(C) the basis of such property is determined in whole or in part by reference to the basis of any property in the hands of another corporation which was not an S corporation throughout all of the period described in subparagraph (B) before the transfer by such other corporation and during which such other corporation was in existence,

then subsection (a) shall apply for the taxable year, but the amount of the tax determined under subsection (b) shall not exceed a tax, determined as provided in section 1201(a), on the net capital gain attributable to property acquired as provided in subparagraph (B) and having a basis described in subparagraph (C).

(d) DETERMINATION OF TAXABLE INCOME.—For purposes of subsections (a)(2) and (b)(2), taxable income of the corporation shall be determined under section 63(a) without regard to—

(1) the deduction allowed by section 172 (relating to net operating loss deduction), and

(2) the deductions allowed by part VIII of subchapter B (other than the deduction allowed by section 248, relating to organization expenditures).

PART IV—DEFINITIONS; MISCELLANEOUS

Sec. 1377. Definitions and special rule.
Sec. 1378. Taxable year of S corporation.
Sec. 1379. Transitional rules on enactment.

SEC. 1377. DEFINITIONS AND SPECIAL RULE.

(a) PRO RATA SHARE.—For purposes of this subchapter—

(1) IN GENERAL.—Except as provided in paragraph (2), each shareholder's pro rata share of any item for any taxable year shall be the sum of the amounts determined with respect to the shareholder—

(A) by assigning an equal portion of such item to each day of the taxable year, and

(B) then by dividing that portion pro rata among the shares outstanding on such day.

(2) ELECTION TO TERMINATE YEAR.—Under regulations prescribed by the Secretary, if any shareholder terminates his interest in the corporation during the taxable year and all persons who are shareholders during the taxable year agree to the application of this paragraph, paragraph (1) shall be applied as if the taxable year consisted of 2 taxable years the first of which ends on the date of the termination.

(b) POST-TERMINATION TRANSITION PERIOD.—

(1) IN GENERAL.—For purposes of this subchapter, the term "post-termination transition period" means—

(A) the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of—

(i) the day which is 1 year after such last day, or

(ii) the due date for filing the return for such last year as an S corporation (including extensions), and

(B) the 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year.

(2) DETERMINATION DEFINED.—For purposes of paragraph (1), the term "determination" means—

(A) a court decision which becomes final,

(B) a closing agreement, or

(C) an agreement between the corporation and the Secretary that the corporation failed to qualify as an S corporation.

(c) MANNER OF MAKING ELECTIONS, ETC.—Any election under this subchapter, and any revocation under section 1362(d)(1), shall be made in such manner as the Secretary shall by regulations prescribe.

SEC. 1378. TAXABLE YEAR OF S CORPORATION.

(a) GENERAL RULE.—For purposes of this subtitle—

(1) an S corporation shall not change its taxable year to any accounting period other than a permitted year, and

(2) no corporation may make an election under section 1362(a) for any taxable year unless such taxable year is a permitted year.

(b) PERMITTED YEAR DEFINED.—For purposes of this section, the term "permitted year" means a taxable year which—

(1) is a year ending Decembber 31, or

(2) is any other accounting period for which the corporation establishes a business purpose to the satisfaction of the Secretary.

(c) EXISTING S CORPORATIONS REQUIRED TO USE PERMITTED YEAR AFTER 50-PERCENT SHIFT IN OWNERSHIP.—

(1) IN GENERAL.—A corporation which is an S corporation for a taxable year which includes December 31, 1982, shall not be treated as an S corporation for any subsequent taxable year beginning after the first day on which more than 50 percent of the stock is newly owned stock unless such subsequent taxable year is a permitted year.

(2) NEWLY OWNED STOCK.—For purposes of paragraph (1), the stock held by any person on any day shall be treated as newly owned stock to the extent that—

(A) the percentage of the stock of such corporation owned by such person on such day, exceeds,

(B) the percentage of the stock of such corporation owned by such person on December 31, 1982.

(3) STOCK ACQUIRED BY REASON OF DEATH.—For purposes of paragraph (2), if—

(A) a person acquires stock in the corporation after December 31, 1982, and

(B) such stock was acquired by reason of the death of a person who held such stock (or predecessor stock) on such date,

then such stock shall be treated as held on December 31, 1982, by the person described in subparagraph (A). A similar rule shall apply in the case of a series of such acquisitions.

SEC. 1379. TRANSITIONAL RULES OF ENACTMENT.

(a) OLD ELECTIONS.—Any election made under section 1372(a) (as in effect before the enactment of the Subchapter S Revision Act of 1982) shall be treated as an election made under section 1362.

(b) REFERENCES TO PRIOR LAW INCLUDED.—In applying this subchapter to any taxable year beginning after December 31, 1982, any reference in this subchapter to another provision of this subchapter shall, to the extent not inconsistent with the purposes of this subchapter, include a reference to the corresponding provision as in effect before the enactment of the Subchapter S Revision Act of 1982.

(c) DISTRIBUTIONS OF UNDISTRIBUTED TAXABLE INCOME.—If a corporation was an electing small business corporation for the last pre-enactment year, subsections (f) and (d) of section 1375 (as in effect before the enactment of the Subchapter S Revision Act of 1982) shall continue to apply with respect to distributions of undistributed taxable income for any taxable year beginning before January 1, 1983.

(d) CARRYFORWARDS.—If a corporation was an electing small business corporation for the last preenactment year and is an S corporation for the 1st postenactment year, any carryforward to the 1st postenactment year which arose in a taxable year for which the corporation was an electing small business corporation shall be treated as arising in the 1st postenactment year.

(e) PREENACTMENT AND POSTENACTMENT YEARS DEFINED.—For purposes of this subsection—

(1) LAST PREENACTMENT YEAR.—The term "last preenactment year" means the last taxable year of a corporation which begins before January 1, 1983.

(2) 1ST POSTENACTMENT YEAR.—The term "1st postenactment year" means the 1st taxable year of a corporation which begins after December 31, 1982.

Subtitle C—Employment Taxes

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CHAPTER 24—COLLECTION OF INCOME TAX AT SOURCE ON WAGES

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Subchapter B—Withholding From Interest and Dividends

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SEC. 3453. PAYOR DEFINED.

(a) GENERAL RULE.—Except as otherwise provided in this subchapter, for purposes of this subchapter, the term "payor" means the person paying or crediting the interest, dividend, or patronage dividend.

(b) CERTAIN MIDDLEMEN TREATED AS PAYORS.—For purposes of this subchapter—

(1) IN GENERAL.—To the extent provided in regulations—

(A) any custodian for, or nominee of, the payee,

(B) any corporate trustee of a trust which is the payee, [or]

(C) any person which collects the payment for the payee or otherwise acts as a middleman between the payor and the payee, *or*

(D) any S corporation which receives any payment,

shall be treated as a payor with respect to the payment.

SEC. 3454. DEFINITIONS OF INTEREST, DIVIDEND, AND PATRONAGE DIVIDEND.

(a) INTEREST DEFINED.—* * *

(b) DIVIDEND DEFINED.—For purposes of this subchapter—

(1) GENERAL RULE.—The term "dividend" means—

(A) any distribution by a corporation which is a dividend (as defined in section 316), and

(B) any payment made by a stockbroker to any person as a substitute for a dividend (as so defined).

[(2) SUBCHAPTER S DISTRIBUTIONS AFTER CLOSE OF YEAR.—The term "dividend" includes any distribution described in section

1375(f) (relating to distributions by electing small business corporations after the close of the taxable year).]

[(3)] (2) EXCEPTIONS.—The term "dividend" shall not include—

(A) any amount paid as a distribution of stock described in section 305(e)(2)(A) (relating to reinvestment of dividends in stock of public utilities),

(B) any amount which is treated as a taxable dividend by reason of section 302 (relating to redemptions of stock), 306 (relating to disposition of certain stock), 356 (relating to receipt of additional consideration in connection with certain reorganizations), or 1081(e)(2) (relating to certain distributions pursuant to order of the Securities and Exchange Commission),

(C) any amount described in subparagraph (D), (E), or (F) of subsection (a)(2),

(D) to the extent provided in regulations, any amount paid by a foreign corporation not engaged in a trade or business in the United States,

(E) any amount which is a capital gain dividend distributed by—

(i) a regulated investment company (as defined in section 852(b)(3)(C)), or

(ii) a real estate investment trust (as defined in section 857(b)(3)(C)),

(F) any amount which is an exempt-interest dividend of a regulated investment company (as defined in section 852(b)(5)(A)), *and*

(G) any amount paid or treated as paid by a regulated investment company during a year if, under regulations prescribed by the Secretary, it is anticipated that at least 95 percent of the dividends paid or treated as paid during such year (not including capital gain distributions) will be exempt-interest dividends [, and].

[(H) any amount described in section 1373 (relating to undistributed taxable income of electing small business corporations).]

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Subtitle D—Miscellaneous Excise Taxes

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CHAPTER 45—WINDFALL PROFIT TAX ON DOMESTIC CRUDE OIL

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Subchapter B—Categories of Oil

SEC. 4992. INDEPENDENT PRODUCER OIL.

(a) GENERAL RULE.—For purposes of this chapter, the term "independent producer oil" means that portion of an independent pro-

ducer's qualified production for the quarter which does not exceed such person's independent producer amount for such quarter.

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(f) S CORPORATION TREATED AS PARTNERSHIP.—For the purposes of subsections (d) and (e)—

(1) an S corporation shall be treated as a partnership, and

(2) the shareholders of the S corporation shall be treated as partners of such partnership.

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Subchapter C—Miscellaneous Provisions

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SEC. 4996. OTHER DEFINITIONS AND SPECIAL RULES.

(a) PRODUCER AND OPERATOR.—For purposes of this chapter—

(1) PRODUCER.—

(A) IN GENERAL.—Except as provided in subparagraph (B), the term "producer" means the holder of the economic interest with respect to the crude oil.

(B) PARTNERSHIPS.—

(i) IN GENERAL.—If (but for this subparagraph) a partnership would be treated as the producer of any crude oil.

(I) such crude oil shall be allocated among the partners of such partnership, and

(II) any partner to whom such crude oil is allocated (and not the partnership) shall be treated as the producer of such crude oil.

(ii) ALLOCATION.—Except to the extent otherwise provided in regulations, any allocation under clause (i)(I) shall be determined on the basis of a person's proportionate share of the income of the partnership.

(C) SUBCHAPTER S CORPORATIONS.—

(i) IN GENERAL.—If (but for this subparagraph) an S corporation would be treated as a producer of any crude oil—

(I) such crude oil shall be allocated among the shareholders of such corporation, and

(II) any shareholder to whom such crude oil is allocated (and not the S corporation) shall be treated as the producer of such crude oil.

(ii) ALLOCATION.—Except to the extent otherwise provided in regulations, any allocation under clause (i)(I) shall be determined on the basis of the shareholder's pro rata share (as determined under section 1377(a)) of the income of the corporation.

Subtitle F—Procedure and Administration

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CHAPTER 61—INFORMATION AND RETURNS

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Subchapter A—Returns and Records

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PART III—INFORMATION RETURNS

Subpart A. Information concerning persons subject to special provisions.
Subpart B. Information concerning transactions with other persons.
Subpart C. Information regarding wages paid employees.
Subpart D. Information concerning private foundations.
Subpart E. Registration of and information concerning pensions, etc.
Subpart F. Information concerning income tax return preparers.

Subpart A—Information Concerning Persons Subject to Special Provisions

Sec. 6031. Return of partnership income.
Sec. 6032. Returns of banks with respect to common trust funds.
Sec. 6033. Returns by exempt organizations.
Sec. 6034. Returns by trusts described in section 4947(a)(2) claiming charitable deductions under section 642(c).
Sec. 6035. Returns of officers, directors, and shareholders of foreign personal holding companies.
Sec. 6036. Notice of qualification as executor or receiver.
Sec. 6037. Return of [electing small business corporation] *S corporation.*

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SEC. 6037. RETURN OF [ELECTING SMALL BUSINESS CORPORATION.] *S CORPORATION.*

Every [electing small business corporation (as defined in section 1371(b))] *S corporation* shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, the names and addresses of all persons owning stock in the corporation at any time during the taxable year, the number of shares of stock owned by each shareholder at all times during the taxable year, the amount of money and other property distributed by the corporation during the taxable year to each shareholder, the date of each such distribution, [and such other information] *each shareholder's pro rata share of each item of the corporation for the taxable year, and such other information*, for the purpose of carrying out the provisions of subchapter S of chapter 1, as the Secretary may by forms and regulations prescribe. Any return filed pursuant to this section shall, for purposes of chapter 66 (relating to limitations), be treated as a return filed by the corporation under section 6012.

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Subpart B—Information Concerning Transactions With Other Persons

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SEC. 6042. RETURNS REGARDING PAYMENTS OF DIVIDENDS AND CORPORATE EARNINGS AND PROFITS.

(a) REQUIREMENT OF REPORTING.—

(b) DIVIDEND DEFINED.—

(1) GENERAL RULE.—For purposes of this section, the term "dividend" means—

(A) any distribution by a corporation which is a dividend (as defined in section 316); and

(B) any payment made by a stockbroker to any person as a substitute for a dividend (as so defined).

[(2) EXCEPTIONS.—For purposes of this section, the term "dividend" does not include—

[(A) to the extent provided in regulations prescribed by the Secretary, any distribution or payment—

[(i) by a foreign corporation, or

[(ii) to a foreign corporation, a nonresident alien, or a or a partnership not engaged in trade or business in the United States and composed in whole or in part of nonresident aliens; and

[(B) any amount described in section 1373 (relating to undistributed taxable income of electing small business corporations).]

(2) EXCEPTIONS.—For purposes of this section, to the extent provided in regulations prescribed by the Secretary, the term "dividend" does not include any distribution or payment—

(A) by a foreign corporation, or

(B) to a foreign corporation, a nonresident alien, or a partnership not engaged in a trade or business in the United States and composed in whole or in part of nonresident aliens.

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CHAPTER 63—ASSESSMENT

SUBCHAPTER A. In general.
SUBCHAPTER B. Deficiency procedures in the case of income, estate, gift, and certain excise taxes.
SUBCHAPTER C. Tax treatment of partnership items.
SUBCHAPTER D. Tax treatment of subchapter S items.

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Subchapter D—Tax Treatment of Subchapter S Items

Sec. 6241. Tax treatment determined at corporate level.
Sec. 6242. Shareholder's return must be consistent with corporate return or Secretary notified of inconsistency.
Sec. 6243. All shareholders to be notified of proceedings and given opportunity to participate.
Sec. 6244. Certain partnership provisions made applicable.
Sec. 6245. Subchapter S item defined.

SEC. 6241. TAX TREATMENT DETERMINED AT CORPORATE LEVEL.

Except as otherwise provided in regulations prescribed by the Secretary, the tax treatment of any subchapter S item shall be determined at the corporate level.

SEC. 6242. SHAREHOLDER'S RETURN MUST BE CONSISTENT WITH CORPORATE RETURN OR SECRETARY NOTIFIED OF INCONSISTENCY.

A shareholder of an S corporation shall, on such shareholder's return, treat a subchapter S item in a manner which is consistent with the treatment of such item on the corporate return unless the shareholder notifies the Secretary (at the time and in the manner prescribed by regulations) of the inconsistency.

SEC. 6243. ALL SHAREHOLDERS TO BE NOTIFIED OF PROCEEDINGS AND GIVEN OPPORTUNITY TO PARTICIPATE.

In the manner and at the time prescribed in regulations, each shareholder in a corporation shall be given notice of, and the right to participate in, any administrative or judicial proceeding for the determination at the corporate level of any subchapter S item.

SEC. 6244. CERTAIN PARTNERSHIP PROVISIONS MADE APPLICABLE.

The provisions of—

(1) subchapter C which relate to—

(A) assessing deficiencies, and filing claims for credit or refund, with respect to partnership items, and

(B) judicial determination of partnership items, and

(2) so much of the other provisions of this subtitle as relate to partnership items,

are (except to the extent modified or made inapplicable in regulations) hereby extended to and made applicable to subchapter S items.

SEC. 6245. SUBCHAPTER S ITEM DEFINED.

For purposes of this subchapter, the term "subchapter S item" means any item of an S corporation to the extent regulations prescribed by the Secretary provide that, for purposes of this subtitle, such item is more appropriately determined at the corporate level than at the shareholder level.

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CHAPTER 64—COLLECTION

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Subchapter E—Collection of State Individual Income Taxes

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SEC. 6362. QUALIFIED STATE INDIVIDUAL INCOME TAXES.

(a) QUALIFIED STATE INDIVIDUAL INCOME TAXES DEFINED.— * * *

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(f) ADDITIONAL REQUIREMENTS.—A tax imposed by a State shall meet the requirements of this subsection only if—

(1) STATE AGREEMENT MUST BE IN EFFECT FOR PERIOD CONCERNED.— * * *

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(7) PARTNERSHIPS, TRUSTS, [SUBCHAPTER S CORPORATIONS,] AND OTHER CONDUIT ENTITIES.—Under the State law the tax treatment of—

(A) partnerships and partners,

(B) trusts and their beneficiaries,

(C) estates and their beneficiaries,

(D) [electing small business corporations (within the meaning of section 1371(a))] *S corporations* and their shareholders, and

(E) any other entity and the individuals having beneficial interests therein, to the extent that such entity is treated as

a conduit for purposes of the taxes imposed by chapter 1, shall correspond to the tax treatment provided therefor in the case of the taxes imposed by chapter 1.

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CHAPTER 68—ADDITIONS TO THE TAX, ADDITIONAL AMOUNTS, AND ASSESSABLE PENALTIES

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Subchapter A—Additions to the Tax and Additional Amounts

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SEC. 6661. SUBSTANTIAL UNDERSTATEMENT OF LIABILITY.

(a) ADDITION TO TAX.—If there is a substantial understatement of income tax for any taxable year, there shall be added to the tax an amount equal to 10 percent of the amount of any underpayment attributable to such understatement.

(b) DEFINITION AND SPECIAL RULE.—

(1) SUBSTANTIAL UNDERSTATEMENT.—

(A) IN GENERAL.—For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of—

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) SPECIAL RULE FOR CORPORATIONS.—In the case of a corporation other than an [electing small business corporation (as defined in section 1371(b))] *S corporation* or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000 for $5,000".

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SECTION 408 OF THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

EXEMPTIONS FROM PROHIBITED TRANSACTIONS

SEC. 408. (a) * * *

* * * * * * *

(d) Section 407(b) and subsections (a), (b), (c), and (e) of this section shall not apply to any transaction in which a plan, directly or indirectly—

(1) lends any part of the corpus or income of the plan to;

(2) pays any compensation for personal services rendered to the plan to; or

(3) acquires for the plan any property from or sells any property to;

any person who is with respect to the plan an owner-employee (as

defined in section 401(c)(3) of the Internal Revenue Code of 1954), a member of the family (as defined in section 267(c)(4) of such Code) of any such owner-employee, or a corporation controlled by any such owner-employee through the ownership, directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation. For purposes of this subsection a shareholder employee (as defined in section 1379 of the Internal Revenue Code of 1954 *as in effect on the day before the date of the enactment of the Subchapter S Revision Act of 1982*) and a participant or beneficiary of an individual retirement account, individual retirement annuity, or an individual retirement bond (as defined in section 408 or 409 of the Internal Revenue Code of 1954) and an employer or association of employers which establishes such an account or annuity under section 408(c) of such code shall be deemed to be an owner-employee.

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